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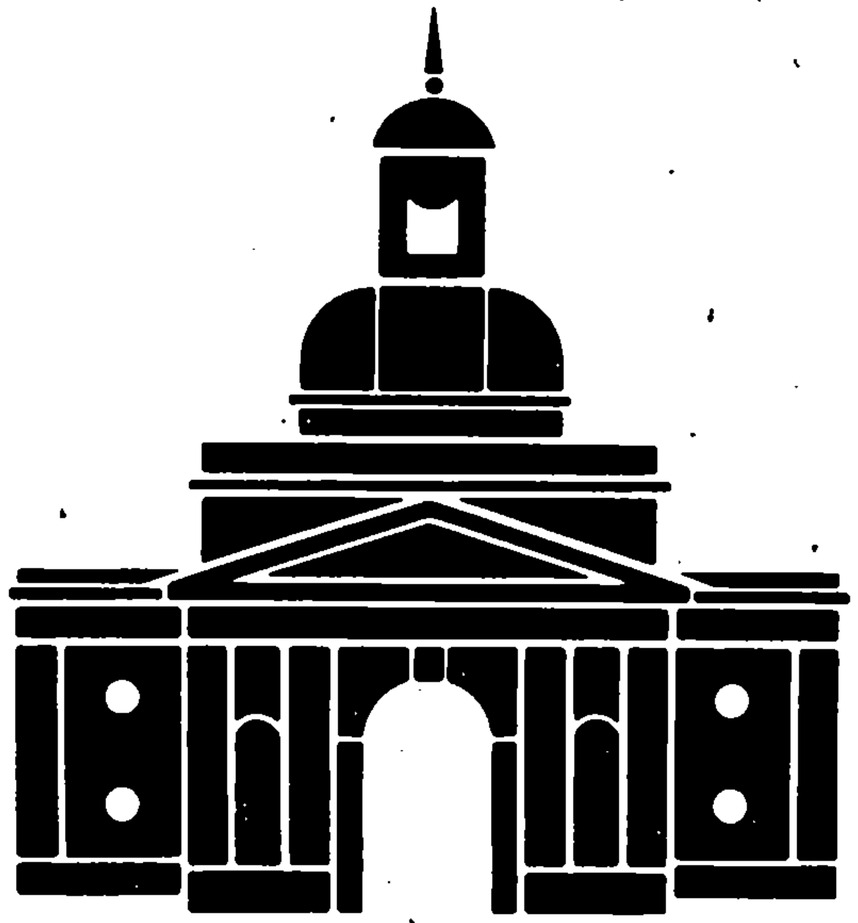

Bulletin 1989

INTERNATIONAL BUREAU OF
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■ OFFICIAL JOURNAL OF THE INTERNATIONAL FISCAL ASSOCIATION ■

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Art. 2 – Objects

1. The objects of the foundation shall be to organise and maintain a documentation centre for the purpose of providing information about and explanations of national and international taxation and the application thereof, as well as promoting the study of taxation in general.
2. In the realisation of its objects the foundation shall strive to maintain good co-operation with its founder, the International Fiscal Association, hereinafter referred to as "I.F.A.", which set up the foundation as an independent entity.

Art. 3

1. The foundation shall endeavour to achieve its objects:

L'OBJET DU BUREAU

Le Bureau International de Documentation Fiscale fut fondé en 1938. Pour des raisons d'organisation, ce Bureau est établi comme une fondation séparée conformément au droit civil néerlandais. Le Bureau est une institution scientifique, indépendante, sans but lucratif et sans objet politique, dont le but est défini dans les statuts comme suit:

Art. 2 – Objets

1. La fondation a aussi bien pour objet d'organiser et de tenir à jour un centre de documentation permettant de fournir des informations et explications sur la fiscalité nationale et internationale et son application, que de promouvoir l'étude de la fiscalité en général.
2. Pour la réalisation de ces objets, la fondation devra chercher à entretenir une bonne coopération avec sa fondatrice, l'Association Fiscale Internationale, ci-après intitulée I.F.A. (International Fiscal Association), qui a créé la fondation comme entité indépendante.

Art. 3

1. La fondation s'efforcera pour la réalisation de ces objets:

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For an index of Articles, Reports and Documents, and Bibliography of the Bulletin, published in 1989, and a list of authors, see pages 586 et seq.

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In close cooperation with the I.F.A., and with the aid of expert correspondents throughout the world, the Bureau acquires as much information as possible in the field of international and comparative tax law. The Bureau is thus able to supply data (but not advice) on specific tax problems. A fee, necessary for the maintenance and extension of the Bureau, is charged on a time/cost basis. The Bureau has published several series of monographs including "Selected Monographs on Taxation" (a joint venture with Harvard Law School, International Tax Program).

Par une coopération étroite avec l'I.F.A. et avec l'aide de correspondants à travers le monde, le Bureau rassemble toutes les données possibles en matière de droit fiscal international et comparé. De cette façon, le Bureau est à même de fournir des renseignements, mais non des avis, concernant des problèmes fiscaux spéciaux. Des honoraires, nécessaires au maintien et à l'expansion du Bureau, sont demandés en fonction du temps nécessaire et du coût. Le Bureau a publié un certain nombre de monographies dont des monographies sur la fiscalité (études réalisées en association avec Harvard Law School, International Tax Program).

The Bureau also publishes *European Taxation,* a monthly journal on the tax systems of Europe. *Tax News Service,* published twice per month, provides rapid information on world-wide tax development. *Supplementary Service to European Taxation* is a loose-leaf reference work.

Le Bureau publie aussi *European Taxation,* revue mensuelle sur les systèmes fiscaux européens. *Tax News Service,* publié deux fois par mois, donne une information rapide, à l'échelle mondiale, de tout ce qui touche à la fiscalité. *Supplementary Service to European Taxation* est un ouvrage de référence présentée sous feuilles mobiles.

The loose-leaf series *Guides to European Taxation* comprises "The Taxation of Patent Royalties, Dividends, Interest, in Europe", "The Taxation of Companies in Europe", "The Taxation of Private Investment Income", "Value Added Taxation in Europe" and "Taxation in European Socialist Countries".

Guides to European Taxation, également une publication sous feuilles mobiles, comprend "The Taxation of Patent Royalties, Dividends, Interest, in Europe", "The Taxation of Companies in Europe", "The Taxation of Private Investment Income", "Value Added Taxation in Europe" et "Taxation in European Socialist Countries".

The Bureau publishes other loose-leaf reference works, *Taxation in Latin America, African Tax Systems, Taxes and Investment in the Middle East, Taxes and Investment in Asia and the Pacific* and *The Tax Treatment of Transfer Pricing.*

Le Bureau publie également *Taxation in Latin America, Systèmes Fiscaux Africains, Taxes and Investment in the Middle East, Taxes and Investment in Asia and the Pacific* et *The Tax Treatment of Transfer Pricing*, ouvrages d'information sous feuilles mobiles.

The compact disc (CD-ROM) comprises virtually all of the world's effective tax treaties, including protocols and model treaties (1000 in total, covering 135 countries).

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The I.F.A. was founded on the 12th of February 1938 by tax experts of a number of countries. Purpose and working-method are defined as follows in the Articles:

Aim – Article 2
The aim of the Association is the study and advancement of international and comparative law in regard to public finance and especially international and comparative fiscal law and the financial and economic aspects of taxation.

Plan of Action – Article 3
The Association shall endeavour by all legal means to realise this aim: (a) by scientific research; (b) by holding congresses and conferences; (c) by publications; (d) by cooperation with all data collecting organisations, especially the International Bureau of Fiscal Documentation in Amsterdam; (e) by all other appropriate methods.

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Conditions of individual membership of national IFA branches for 1990 are: Dfl. 105.–; direct individual members of IFA: Dfl. 115.–; corporate members both direct and of national IFA branches: Dfl. 250.–.

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On 21 October 1988 the Minister for Finance presented his Federal Budget proposals to the House of Representatives. This article highlights several of the tax changes proposed.

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A Press Release was issued on 17 November 1988 concerning the contents of the new double taxation treaty signed by Australia and the People's Republic of China. The allocation of taxing rights between the 2 countries is substantially similar to that adopted in Australia's other modern double taxation agreements. The Press Release is reproduced in this issue.

Arthur Young International:

PUERTO RICO: INDIVIDUAL INCOME TAXES 30

The third article in our series on individual income tax for the expatriate focuses on Puerto Rico. Although Puerto Rican tax legislation is modelled after U.S. legislation, there are differences between the 2 systems, i.e. in particular with respect to personal and dependency exemptions, the deductible portion of various expenses, taxation of married persons and the tax treatment of income items such as interest and dividends. This article describes a number of tax concepts which are of prime importance to expatriates in Puerto Rico.

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On 21 October 1988 the TAMRA was passed by the U.S. Congress. The Act contains a plethora of technical amendments, including the new taxpayer bill of rights. The text of Secs. 6226-6247 is reprinted in this issue.

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Protocoles aux conventions Belgo–Américaine et Franco–Américaine: Mise en relief de points sensibles des conventions fiscales américaines 3

Les Etats-Unis ont récemment conclu des protocoles aux conventions qu'ils ont signées avec la Belgique et la France. Ces protocoles ont été annoncés comme étant les premières possibilités de mise en application de la Réforme Fiscale de 1986 ainsi que la preuve que les Etats-Unis n'ont pas l'intention en principe de déroger aux traités qu'ils ont signés mais qu'ils vont prendre des mesures afin de les modifier lorsque leur législation interne entre en conflit avec eux. Cet article analyse quelques unes des modifications et des conséquences des récents protocols ainsi que la position des Etats-Unis quant à l'utilisation abusive des conventions fiscales.

INHALTSVERZEICHNIS

Dennis J. Olmstead und Niels Dejean:

Die Protokolle zu den Doppelbesteuerungsabkommen zwischen den U.S.A. und Belgien und den U.S.A. und Frankreich: Eine Übersicht der Doppelbesteuerungsabkommenbesorgnisse der U.S.A. 3

Die U.S.A. haben neuerdings Protokolle zu den Doppelbesteuerungsabkommen mit Belgien und Frankreich abgeschlossen und man hat diese Protokolle als eine der ersten Möglichkeiten seitens den U.S.A. angekündigt, um das Steuerreformgesetz 1986 durchzuführen. Auch betrachtet man diese Protokolle als den Beweis, dass die U.S.A. normalerweise nicht die Doppelbesteuerungsabkommen durch einseitige Massnahmen zu beseitigen beabsichtigt, sondern Schritte unternehmen wird, um Doppelbesteuerungsabkommen zu ändern, wenn die nationale Gesetzgebung und ein Doppelbesteuerungsabkommen miteinander kollidieren. Dieser Artikel analysiert einige der Änderungen und Folgen, welche von den neuen Protokollen verursacht wurden, zusammen mit dem Entwicklungsprozess der Politik der U.S.A. bezüglich Abkommenserschleichung.

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John F. Due:
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Le Botswana est l'un des pays les plus petits (quant à sa population) et les moins connus de l'Afrique Tropicale. Le Professeur Due résume la structure fiscale et la nature des principaux impôts du Botswana, à savoir l'impôt sur le revenu, l'impôt agricole, les droits de douane et d'accises ainsi que la taxe sur le chiffre d'affaires.

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Dr. Arno Wohlgemuth:
Vietnam: Lois sur les investissements étrangers et les taxes à l'importation et à l'exportation 22
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Australie: Exposé présenté le 17 novembre 1988 par le ministre des Finances, L'Hon. P.J. Keating, MP: Convention de double imposition entre l'Australie et la Chine 29
Un communiqué de presse a mentionné le 17 novembre 1988 le contenu de la nouvelle convention de double imposition signée entre l'Australie et la République Populaire de Chine. La répartition des droits d'imposition entre les 2 pays est dans ses grandes lignes comparable à celle adoptée par l'Australie dans ses dernières conventions de double imposition. Le communiqué de presse est reproduit ici.

Arthur Young International:
Porto Rico: Impôts sur le revenu des personnes physiques à Porto Rico 30
Le 3ème article de notre série consacrée à l'impôt sur le revenu des personnes physiques applicable aux expatriés analyse la situation à Porto Rico. Bien que la législation fiscale portoricaine suive l'américaine, il y a néanmoins quelques différences entre les deux systèmes; essentiellement en ce qui concerne les exemptions personnelles et celles portant sur les personnes à charge, la quotité déductible de différentes dépenses, l'imposition des personnes mariées et le traitement fiscal de certains revenus comme les intérêts et les dividendes. Cet article analyse un certain nombre de concepts fiscaux qui sont essentiels pour les expatriés à Porto Rico.

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Abdin Ahmed Salama:
Sudan: Die direkten Steuern 17
Die Einführung des Einkommensteuergesetzes 1986 (1986 Income Tax Law) hat die Rolle der direkten Steuern im Sudan wieder neu belebt. Dieser Artikel beschreibt die sudanische Gesetzgebung bezüglich des Einkommens von natürlichen Personen, gesellschaftlichen Gewinnen, Erbschaften, Kapitalgewinnen und Vermögen und vergleicht die Bestimmungen der Gesetzgebung von 1971 mit dem Einkommensteuergesetz 1986.

Arno Wohlgemuth:
Vietnam: Die Gesetzgebung bezüglich Ausländerinvestitionen und Besteuerung von Einfuhr und Ausfuhr 22
Im Jahre 1987 verabschiedete das Nationale Parlament zwei neue Gesetze mit dem Zweck, die Wirtschaftslage Vietnams zu verbessern, die Produktion zu schützen und weiterzuentwickeln und neue Quellen für die Staatseinnahmen zu schaffen. Dieser Artikel gibt eine kurze Beschreibung der wichtigsten Bestimmungen des vietnamesischen Gesetzes bezüglich Ausländerinvestitionen und Besteuerung von Einfuhr und Ausfuhr.

Susan M.C. Lyons:
Malaysia: Kurzer Überblick des Haushaltsentwurfes für 1989 25
Der Finanzminister legte am 21. Oktober 1988 dem Haus der Abgeordneten die Föderalen Haushaltspläne vor. Dieser Artikel beschreibt kurz eine Anzahl der vorgeschlagenen Steueränderungen.

Australien: Die Aussage des Finanzministers, Herrn P.J. Keating, M.P., vom 17. November 1988: Die Abschliessung eines allgemeinen Doppelbesteuerungsabkommen zwischen Australien und der Volksrepublik China 29
In einem Pressebericht wurde am 17. November 1988 der Inhalt des von Australlen und der Volksrepublik China unterzeichneten neuen Doppelbesteuerungsabkommens bekannt gemacht. Die Verteilung der Zuständigkeit, Steuern zu erheben, gleicht im wesentlichen der Verteilung, die in anderen modernen australischen Doppelbesteuerungsabkommen gehandhabt wird. Der Pressebericht ist in diesem Heft abgedruckt.

Arthur Young International:
Puerto Rico: Die Besteuerung von natürlichen Personen 30
Dieser Artikel ist der dritte in einer Reihe von Artikeln über die Besteuerung von ausländischen Arbeitnehmern und befasst sich besonders mit Puerto Rico. Obwohl man bei der Einführung der Einkommensteuer in Puerto Rico die amerikanische Gesetzgebung als Modell genommen hat, bestehen doch bedeutsame Unterschiede zwischen diesen beiden Steuersystemen, besonders bezüglich der persönlichen Abzüge und Abzüge für Personen, die vom Steuerzahler abhängig sind, des abzugsfähigen Teils der verschiedenen Kosten, der Besteuerung von verheirateten Personen und der Besteuerung von Einkünften wie Dividenden und Zinsen. Dieser Artikel beschreibt eine Anzahl von Steuerbegriffen, die für ausländische Arbeitnehmer ausserordentlich wichtig sind.

U.S.A.: Das „technische und andere Angelegenheiten regelnde Einnahmengesetz 1988" (TAMRA): Die Grundrechte der Steuerbürger 35
Das amerikanische Parlament verabschiedete am 21. Oktober 1988 das „TAMRA" Gesetz. Es enthält eine grosse Menge von technischen Gesetzesänderungen sowie die neuen Bestimmungen, welche die Grundrechte den Steuerbürgern gewähren. Der Text der §§ 6226-6247 ist in diesem Heft abgedruckt.

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Belgium–U.S. and France–U.S. Protocols: Highlighting U.S. Tax Treaty Concerns

Dennis J. Olmstead and Niels DeJean

INTRODUCTION

Ever since the Tax Reform Act of 1986 (TRA 1986), certain tax treaties and the United States (U.S.) have mixed like oil and water. The U.S. maintains an uneasy relationship with its present tax treaty partners and has taken a hard line in negotiating new treaties. Recently, the Department of the Treasury has developed and implemented several methods by which the U.S. can achieve specific goals through the alteration of its existing treaties. While not being the same economic power it was in the 50s and 60s the U.S. still wields sufficient economic power to induce other countries to conclude or alter treaties to the U.S.'s benefit or, alternatively, cause damage by terminating the treaty.

Most trading partners receive significant benefits from treaty agreements for the avoidance of double taxation and are loath to lose the advantages. The U.S. is presently, and has been, in a trade deficit situation and continues to view most countries exporting to the U.S. market as receiving more benefits of access to the U.S. than the U.S. receives reciprocally. Therefore, by pulling the carrot of the U.S. marketplace (230 million consumers) ahead of the other contracting party, the U.S. has:

- terminated
- unilaterally overridden
- "mutually" modified

various treaties to gain a perceived advantage. The long-term effects of the tactics applied by the U.S. are unknown. However, it is certain that treaties are important for the avoidance of double taxation in order to alleviate unnecessary burdens on international trade and shall retain considerable value for the major manufacturing and consuming countries.

O. Donaldson Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, on 9 August of this year highlighted the significance of the new Belgian–U.S. protocol (BP) and the new France–U.S. protocol (FP) as the first opportunities to implement the TRA 1986. These protocols are also viewed as evidence that the U.S. does not intend to override tax treaties as a normal course of business, but will diligently work toward rapid modification of the tax treaty when domestic law conflicts with the treaty through a mutual agreement procedure resulting in a protocol.

While it is debatable whether or not these protocols allow implementation of TRA 1986, the provisions are of importance as models of what the U.S. perceives as implementing TRA 1986. In this light, the following pages will illuminate some of the changes and the consequences of these changes including the highlights of the evolving policy position concerning treaty shopping.

In the first part, coverage of specific technical changes will be provided while the second part of this article will discuss the expanding theory of treaty shopping.

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PART I: TECHNICAL CHANGES

Branch profits tax (BPT)

As previously stated, Mr. Chapoton has indicated that these protocols implement TRA 1986. In light of this it is interesting that the Belgian treaty does not permit the BPT and a branch profits tax provision was not negotiated into the protocol. Commentary by the Joint Committee on Taxation Staff indicates that a new U.S.–Belgian tax treaty is expected in the next 12 months and that this understanding that a new treaty will soon be prepared allowed for the present protocol without a BPT clause. The introduction of the treaty shopping provision into the Belgian–U.S. tax treaty will provide for broader coverage and restriction on the use of the treaty than the BPT, but presently we can expect both clauses.

However, the French protocol did consider the BPT which already was a separate article in the French–U.S. tax treaty. France has applied a BPT for many years and therefore this tax has long been treaty protected. With the implementation of a U.S. BPT, the provision is being reviewed and modified.

The Limitations on Benefits article generally identifies the requirements to be a qualified resident of France or the U.S. for treaty purposes that are embodied in U.S. domestic law for BPT. The proposed protocol would allow U.S. application of a BPT to French permanent establishments (PE) in the U.S. and vice versa: French BPT to U.S. PEs in France.

The BPT is limited to 5% of the "dividend equivalent amount" (DEA) for the French PE in the U.S. The DEA is, generally speaking, earnings and profits plus any decrease in the net equity of the PE, less any increase in net equity of the PE.

The BPT rules are to apply to partnerships conducting a trade or business in the other Contracting State as well. France further agrees to grant a credit for BPT charged in the U.S. Lastly, Art. 13 is modified to exempt a French corporation from accumulated earnings tax if the French corporation qualifies under the ownership test of the treaty shopping provisions as discussed hereinafter.

Dividends

The Belgian–U.S. treaty presently does not contain a lower rate of tax on dividends in the event the beneficial owner of the payor is a company owning a minimum percentage of the stock. The BP proposes a lower withholding tax rate of 5% when the beneficial owner owns at least 10% of the voting stock of the payor. This was a request of the Belgian Government in an attempt to lessen the excess foreign tax credit position of U.S. companies in Belgium and keep Belgium competitive with other treaty countries.

The France–U.S. tax treaty provision for dividends has historically been more complex than the Belgium–U.S. provision. The French protocol will alleviate some of the complexity by deleting the rule which treats dividends from a French company with 80% of its previous 3 years' gross income taxable to a U.S. permanent establishment as U.S. source dividends.

The definition of "dividend" is also modified in order to conform with the OECD Model Tax Treaty and the 1981 U.S. Model Tax Treaty. It will now include income from "jouissance" shares or "jouissance" rights, mining shares, founder's shares or other rights, not being debt claims and participating in profits.

Considerable discussion by the Staff concerns the treatment of dividends from Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs).[1] These two entities receive special treatment in that they are conduit entities which are allowed deductions upon the distribution of income. The Staff is of the opinion that these entities should not receive the lowered ownership withholding tax rate of 5%.

The argument centers around the fact that RICs are generally portfolio investment vehicles so they should not be taxed in the same manner as a direct investor holding 10% or more of the company into which it invests (RICs may not generally own more than 5% of the value of the total assets of the issuing company). The RIC is designed as an investment vehicle through which managed funds can be controlled. There exists a distinction between the RIC and a holding company with wholly-owned subsidiaries. Whether this distinction is sufficient to alter the RIC's treaty benefits must be of interest to those entities organizing and investing via a RIC.

The argument against allowing treaty benefits to the REIT is similarly based on the advantages it receives by deducting its dividends from taxable income.

The alteration of domestic law to state that a REIT and a RIC are not corporations for purposes of the tax treaty relief upon intercompany dividends is not sufficient. The Internal Revenue Code (IRC) *treats* both entities as corporations and this is the definitional test adopted in the Treasury Model and the French and Belgian tax treaties. Therefore, renegotiation must be sought if these entities are to lose their present status. Mr. Chapoton indicated that several treaty partners, including France, are interested in negotiating the proper treatment of dividends from RICs and REITs in the near future.

---

1. A RI is a domestic (U.S.) corporation deriving at least 90% of its gross income from dividends, interest or certain security loans and no more than 30% of its gross income from the sale of securities of stock held for less than 3 months. If such company distributes at least 90% of its income currently to shareholders there is no tax levied on the distributed amounts at the RI level. There are other investment requirements for qualification. A trust which has more than one managing trustee, is beneficially owned by more than 100 persons (with no 5 or fewer holding more than 50% of the beneficial interest) and which specializes in investing in real estate and real estate mortgages may, generally speaking, elect to be treated as a REIT. Banks and insurance companies are excluded. There are 3 income tests for qualification as a REIT relating to the purpose of a REIT as a real estate investment vehicle; however, once qualified a REIT which distributes 95% of its taxable income will be taxed only on retained earnings.

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Interest

The FP alters the interest provisions to deem payment of interest and the timing of recognition of the expense to be at the moment the interest expense is accrued. That would indicate that interest withholding would apply when the interest expense is deducted and therefore, the payor who is generally liable to withhold the tax would be under a duty to pay over the interest withholding tax even though the payment has not been made. Domestic law will determine the penalty for failure to withhold. It has been stated that the recipient of the interest which is unpaid, yet expensed, should have no liability for the withholding tax.

Royalties

The FP alters the sourcing rules for royalty payments and installs a 3-part sourcing test.

(1) If the royalty payment is for the use of or the right to use property in the U.S., the payment is deemed to be from the U.S.
(2) For all other royalty payments the payment is sourced in a treaty country if the payor is that country itself, a local authority, a statutory body or a resident of that country.
(3) However, if there is a fixed base or permanent establishment which bears the royalty expense and to which the liability may be attributed then the payment is deemed to arise in the country where the fixed base or permanent establishment is located. This fixed base or permanent establishment must be located in one of the Contracting States in order to override the residency test.

There is also an addition to Art. 11(3) of the phrase "and beneficially owned" which the Staff identifies as a method of providing treaty protection only to beneficial owners of royalty-producing property. However, it appears this could also result in a treaty shopping interpretation in that the beneficial owner may not be a resident and therefore we may look-through the resident owner to the beneficial owner thereby denying treaty benefits.

The timing of the withholding on the royalty payment for tax purposes shall be when the use or right to use the royalty agreement arises. The same withholding duty as mentioned under the interest section would apply here and the payee (recipient of the payments) would have no duty to pay the accrued withholding tax.

Capital gains

The FP clarifies the supremacy of Art. 6 over the Capital Gains provision and thereby clarifies the retention of tax jurisdiction, as set forth in TRA 1986, over business income of a discontinued company discontinuing in year X plus one and the money being repatriated in year X plus 2. The TRA 1986 states in effect that the U.S. retains the right to tax business income as such for 10 years after the cessation of the business. This legislation was needed to stop the tax planning method of accumulating income in a U.S. subsidiary then ceasing operations and in the following tax year repatriating the funds free of tax under the Capital Gains clause of the tax treaty.

Resident

The definition of the term "resident" in both the BP and FP is generally being altered to reflect the TRA 1986 position that governments are residents of the country which they govern for treaty purposes so long as reciprocal treaty protection is granted the U.S.

Without this distinction government activities which are commercial in nature and therefore not exempt from U.S. taxation under domestic law (see IRC Sec. 892) would also not have treaty protection and would thereby be subject to withholding tax at the rate of 30% for dividends, interest and royalties.

Relief from double taxation

U.S. citizens resident in France are granted an exemption from French tax for U.S.-related income derived from specific sources, e.g. payments from:

- the U.S. government;
- regularly traded share of a U.S. entity;
- U.S. resident with less than 25% foreign-source income.

The exemption will cover U.S.-source dividends, interest, royalties and certain capital gains income. Students, trainees, researchers and teachers will be protected under this provision.

Non-discrimination

Throughout 1986 when the BPT provisions of the IRC were introduced and to this day, many tax planners continue to argue the discriminatory impact of this legislation. In response, while not admitting discrimination, the U.S. has modified the non-discrimination provision via the FP to state that BPT is not discriminatory, nor is the French BPT (withholding tax).

While actions after the fact are generally not evidence of prior error in order to induce correction of risks, this clause evidences the impact arguments of discrimination have made.

Entry into force

The Belgian protocol enters into force 15 days after the exchange of instruments of ratification with the provisions for dividends, interest and royalties, credited or paid on or after 1 January 1988 applying retroactively.

The French protocol is less specific as to ratification, referring instead to "completion of the necessary constitutional procedures" for entry into force. Upon the occurrence of these events, the provisions relating to

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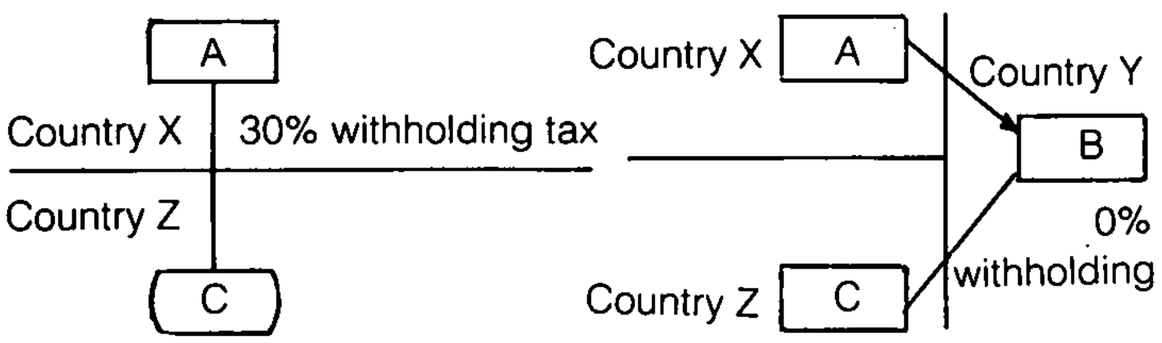
withholding of tax at source shall apply as of the first day of the second month following notification. The BPT provisions are effective for profits realized in any taxable year ending on or after the date of entry into force of the protocol. The exemption for certain income of U.S. citizens resident in France is retroactive to 1 January 1988.

PART II: LIMITATION ON BENEFITS

A review of the treaty activities of the U.S. during the last 8 years highlights one area above all others: treaty shopping. The U.S. will go to extreme lengths to stop the alleged use and abuse of tax treaties by "non-residents". This is clear in the recent branch profits legislation, the new sourcing rules and in the recently signed protocols with Belgium and France, which are the forerunners of the U.S.'s more conciliatory stance with its trading partners.

Both the BP and the FP review and either add a provision (BP) or strengthen the present provision (FP) concerning the limitation on benefits. This is a significant indication of U.S. interest in discontinuing treaty shopping by third parties not intended to have protection under the pertinent treaty.

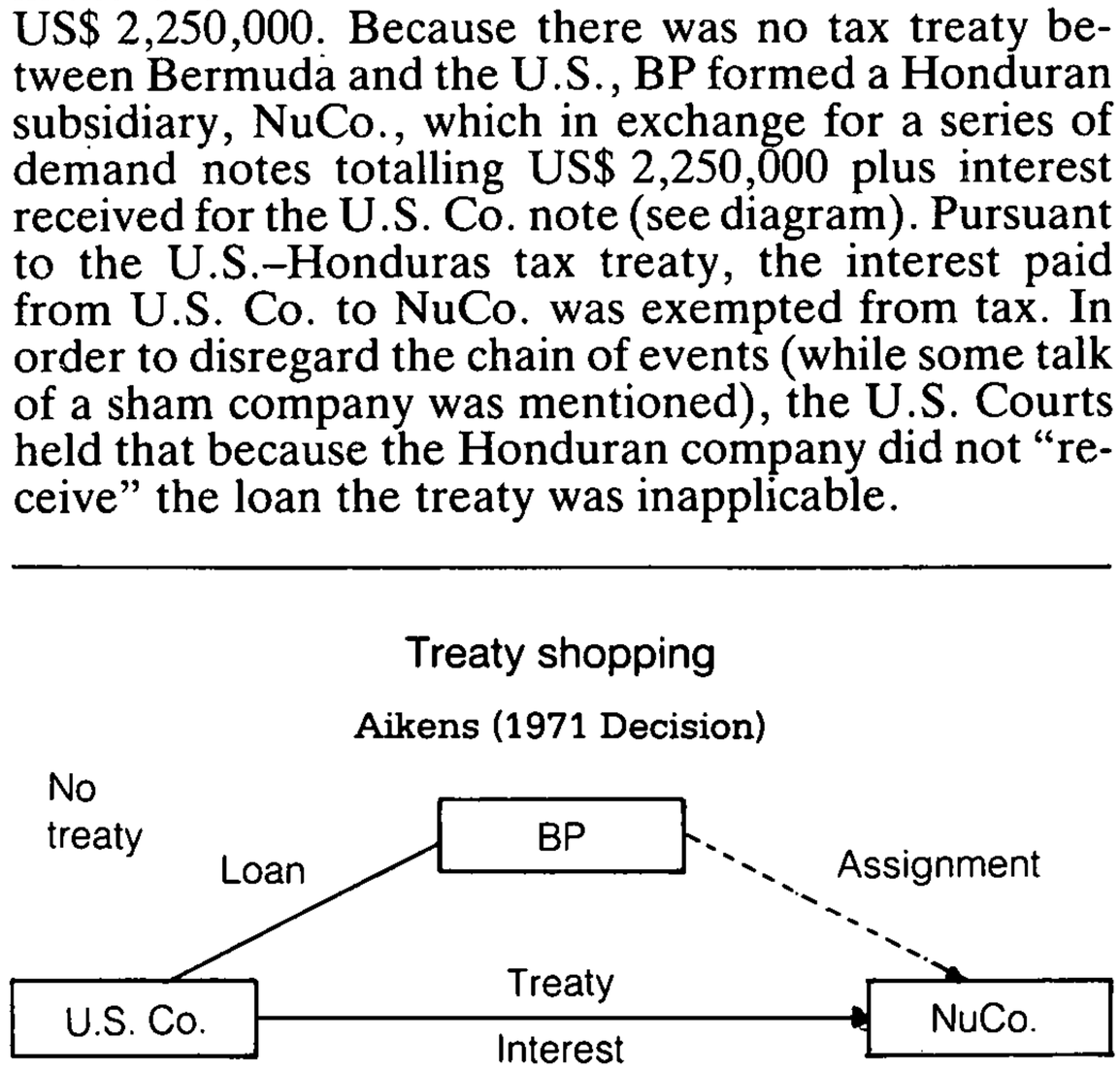
The "plain vanilla" treaty shopping situation occurs when "A", a resident of Country X which has no treaty with Country Z has a subsidiary, "C", in Country Z. "A" organizes, "B", in Country Y which has a treaty with Country Z. By this means, without a limitation of benefits provision, "A" has the advantages of the Y-Z treaty. Assuming Z imposes a withholding tax of 30% with non-treaty countries, but in the case of Country Y has a negotiated rate of 0%, the remittance via Y will be 100% of the income, as opposed to 70% when remitted directly to Country X. Country Y, in the example, must be willing to forego tax on the income received by B or impose minimal taxation on the income flowing back to Country X, whether by means of a treaty between Country X and Y or because of a tax policy Country Y intends to develop (e.g. tax haven, finance center, reinsurance center), in order to complete the conduit and make the use of the tax treaty advantageous upon repatriation of the funds.



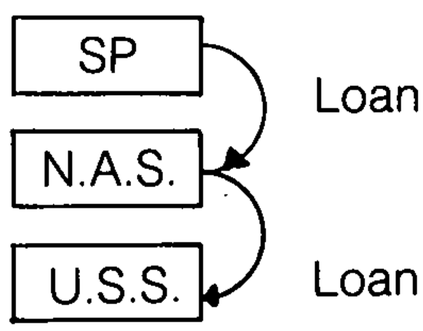
Since treaties are negotiated to provide reciprocal benefits to the contracting parties, the derivation of benefits by a non-contracting party results in unilateral benefits to the non-contracting party. This may minimize the bargaining power of a country when negotiating a treaty with a non-treaty country if the residents of one of the negotiating countries can receive the same benefits by means of an alternative treaty. The U.S. feels this is a major factor hindering expansion of its treaty network.

Prior to the termination of the U.S.–Netherlands Antilles tax treaty, it was common to use the Netherlands Antilles as a conduit for investment into the U.S. The treaty between the U.S. and the Netherlands Antilles reduced withholding tax to 0% on interest, and the Netherlands Antilles, while officially charging 30% tax on the income, in accordance with the tax policy of the Netherlands Antilles, allowed an effective reduction of this rate by reducing the income (base) subject to taxation. The use of this island nation for tax planning purposes resulted in the now famous Revenue Rulings 84-152 and 84-153 which were subsequently explained in Revenue Ruling 87-89. The first view of the treaty shopping theory occurred in the *Aikens* case.[2] A general review of these cases will assist to more fully understand the treaty shopping policy of the U.S.

Starting with the *Aikens* case: Bermuda Parent (BP), located in the Bahamas, owns a subsidiary (U.S. Co.) in the U.S. A loan was made from BP to U.S. Co. for US$ 2,250,000. Because there was no tax treaty between Bermuda and the U.S., BP formed a Honduran subsidiary, NuCo., which in exchange for a series of demand notes totalling US$ 2,250,000 plus interest received for the U.S. Co. note (see diagram). Pursuant to the U.S.–Honduras tax treaty, the interest paid from U.S. Co. to NuCo. was exempted from tax. In order to disregard the chain of events (while some talk of a sham company was mentioned), the U.S. Courts held that because the Honduran company did not "receive" the loan the treaty was inapplicable.



The test that NuCo. needed to "receive" the proceeds of the loan was, while not fully explained in the case, expanded in Revenue Rulings 84-152 and 84-153. The seminal situation involved a Swiss Parent (SP) lending money to a Netherlands Antilles subsidiary (NAS) which onlends the funds to a U.S. subsidiary (U.S.S.).



2. *Aikens Industries, Inc.*, 56 Tax Court 925 (1971).

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The IRS ruled that, in case of a back-to-back loan, the intermediary must have "dominion and control" over the loan.

This prompted some tax advisers to suggest concluding "guarantees" with banks which would then lend the money to the U.S. subsidiary. This position was made untenable by Revenue Ruling 87-89 in which the Internal Revenue Service (IRS) ruled that the loan from the bank must not be as a result of a guarantee or other agreement, but must be a normal commercial agreement which would have been concluded with any unrelated party under the same or similar circumstances.[3]

In light of the increased use of treaty shopping for tax planning purposes, the U.S. has developed a provision during the past 25 years which is intended to inhibit treaty shopping.

The early treaty shopping provisions, often titled "Investment or holding companies", generally denied benefits of the treaty to entities receiving special tax benefits *and* if 25% or more of the capital of the entity is owned by either non-residents or U.S. citizens. This applied only to dividends, interest and royalties. The U.S. Model Tax Treaty of 1977 contains such a provision.

More recently, as is seen in the BP and the French tax treaty, the provision has been expanded (see the U.S. Model Tax Treaty 1981) with a lengthy discussion concerning the meaning of the term residency as defined by means of:
(1) ownership by residents in the Contracting State;
(2) limited third country liability;
(3) traded on a recognized securities exchange in the Contracting State;
(4) active trade or business in the Contracting State.

A review of the specifics of the French and Belgian protocols will indicate the U.S. is being less restrictive than the position exhibited in the 1981 Model. This could indicate that there is some room for negotiation by parties which do not have a history as a treaty shopping conduit. As long as the U.S. feels secure that the agreed upon provision effectively inhibits potential treaty shopping abuses the negotiations should retain some latitude. A review of the 4 points follows.

1. Ownership test

The most important change, in comparison with the 1981 Model, is the acceptance of U.S. citizens as treaty protected individuals when investing in the other country. There is no reason not to protect these individuals as they are under the umbrella of the bilateral agreement and should not be viewed as treaty shoppers. This is in line with the purpose of the provision in that it continues to limit the benefits to residents of the Contracting States. This step is a positive movement on the part of the Department of the Treasury for taxpayers.

Another positive change is the significantly lowered ownership requirements. The 1981 Model required 75% resident ownership, while the Belgian protocol looks for 50% or more ownership by residents of either Belgium, the U.S. or U.S. citizens. While some treaties have required 75% resident ownership in order to receive treaty protection, 50% appears to be the norm in the case of countries without a treaty shopping history.

2. Limited third country liability

As a second part to the ownership test, a base erosion rule has been added. The paying of debt in the form of interest or royalties is generally a deduction as a business expense and as such reduces or erodes the tax base of the taxpayer. Therefore, the base erosion rule requires that not more than 50% of the gross income of the recipient may be used to meet liabilities for interest or royalties to persons who are not residents of one of the Contracting States.

This situation may arise where a resident owner of a company in a Contracting State has outstanding debts to non-residents of 95% of the company's capital. In other words, this is a thinly capitalized company with a 19 to 1 ratio of debt to equity. In this case, if more than 50% of the company's income is used to meet interest liabilities of neither residents nor citizens of the U.S., which would occur if a repayment schedule is used which would split profits in a manner similar to the debt/equity ratio, then the company would lose its treaty protection.

Company A

Gross income	100	
Interest expense deduction	95	
Taxable income	5	= No treaty protection

These 2 tests (1 and 2) are a combined hurdle for treaty protection under the anti-treaty shopping provisions presently promulgated by the Department of the Treasury. That is, both tests – ownership and base erosion – must be met in order to receive the benefits of the treaty.

3. Recognized securities exchange

The other important clause in the BP anti-treaty shopping provision concerns the recognized securities exchange or publicly quoted companies exception. This clause looks to substantial and regular trading of more than 50% of a company's principal class of shares on a recognized securities exchange. The clause allows for substantial trading of the shares of a holding company which holds the shares of the company at issue. The provision contains an error as the clause refers to "the Belgian Stock Exchange" of which there is none;[4] however, this should be easily rectified. The recognized U.S. exchanges are the NASDAQ system and any other stock exchange registered with the SEC.

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3. For an explanation see "Investment of Earnings in U.S. Property", 28 *European Taxation* 2 (1988) at 66.
4. Belgium has 4 separate regional exchanges in Brussels, Antwerp, Ghent and Liege.

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4. Active trade or business

Lastly, the BP anti-treaty shopping provision provides for an active trade or business exception. This is a U.S. tax concept which is difficult to qualify. Being an extremely subjective phrase it may cause some difficulty; however, the intent of the Treasury Department in using this term is to look for companies controlled by third parties, but which are active in the contracting party's state. This active business may receive income from a contracting party's state and still receive treaty protection even though the owners of the active business are non-residents under the treaty.

The active trade or business exception is intended not to apply where the principal activities of the entity are making or managing investments in the source country. This would identify the Belgian Coordination Center (BCC), actively managing investments in the source country, as not performing the requisite active trade or business. Furthermore, because the BCC receives special tax treatment it is viewed as not having a good business purpose by the Joint Committee on Taxation Staff.

Generally, the active trade or business must meet a requirement of a good business purpose. As the Belgian government intended the BCC to attract foreign capital for local investment, few non-U.S. organized BCCs will meet the requirements. If a BCC has been formed as a subsidiary by a third country and is investing into the U.S. it may lose treaty protection. It is the Staff's conclusion that the BCC must, failing this test, either meet the ownership (50% Belgian residents or U.S. citizens) and base erosion rule or public company test if it is to receive treaty protection.

CONCLUSION

The comparison of these 2 protocols evidence the different priorities and complexities which arise in the negotiation process between the U.S. and 2 similarly situated countries. The continued negotiation by the U.S. of treaty shopping provisions emphasizes the importance of this to the general international tax policy of the U.S. There remain many treaties outstanding without such a provision and a few of these treaties are extensively used for tax planning purposes. When and if these treaties will be renegotiated is of major importance to tax planners and can have a major impact on the tax policy of the other contracting party. It appears that the U.S. will actively proceed to renegotiate its present treaties to include an anti-treaty shopping provision as well as provisions needed as a result of TRA 1986. If the U.S. is successful at renegotiating the treaties with a majority of the countries in its treaty network, any country failing to renegotiate may be viewed as an abusive treaty shopping site and thereby precipitate termination. Several of the older treaties still in effect would appear to risk such a response.

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The Tax Structure of Botswana

By John F. Due

Mr. Due is a Professor of Economics, Emeritus, at the University of Illinois, Urbana-Champaign. This paper is based on research conducted by him in September 1988. The author is greatly indebted to many members of the staff of the Botswana Ministry of Finance and Development Planning for their time and assistance.

Botswana is one of the smaller, in terms of population, of the countries of Tropical Africa and one of the least known. The primary purpose of this article is to present a summary of the revenue structure and indicate the evolving nature of the major taxes. An understanding of the revenue structure, however, requires a preliminary review of the economy, in many ways not typical of Tropical Africa.

THE ECONOMY OF BOTSWANA

Botswana, known as Bechuanaland in colonial days, then one of the 3 so-called High Commission Territories, is located directly west of Zimbabwe and South Africa, also bordered on the south by South Africa, and on the west and north by Namibia, touching Zambia at only one point on the Zambezi river. The modern economy evolved primarily from that of South Africa, with which it still has very close trading and transport ties, despite strong political differences. A land-locked country, with no access to the Atlantic, most of its trade is with or via South Africa, though it has limited rail and road access to the Indian ocean via Zimbabwe and Mozambique, and via Zambia and Tanzania. The main railroad from South Africa to what are now the 3 Zs – Zimbabwe, Zambia and Zaire – was built by British interests early in the century via Botswana, along the eastern border, seeking to avoid the Afrikaans stronghold of Transvaal, but there is now also a parallel rail line from South Africa directly to Zimbabwe via Beitbridge. The paved road network is limited to the eastern corridor of the country. The predecessor country became a British protectorate in 1985 and, as Botswana, became independent in 1966.

The current population is about 1.2 million, the area 225,000 square miles and a population density of 1.9 per square mile, one of the lowest in the world. Most of the population is concentrated along the eastern edge of the country. The population is primarily rural, about 20% in 1985 (compared to Zambia's 52%); the largest city, Gaberone, has a population of only about 60,000 and there are only 3 other cities with a population in excess of 25,000. There are about 350,000 persons in the economically active population and about 120,000 in formal sector employment. An estimated 50,000 workers are employed in South Africa.

Because of very limited rainfall in most of the country, farming is limited, and about 90% of all food is imported, primarily from South Africa. Much of the country is devoted to cattle raising, about half in large herds, many expatriate-owned, the rest in small herds. Meat, processed primarily in Lobatse, on the rail line in the southeast, is the principal agricultural export, going primarily to Great Britain. The chief export consists of mineral products, primarily diamonds, which yield about 75% of all foreign exchange and over half the Government's revenue. Copper-nickel production has become important, though barely profitable. There are extensive coal supplies, used only for domestic generation of electricity because of limited export markets. No oil has been discovered.

Significant economic developments

The structure of public finance has been influenced significantly by several major trends in the last decade.

First, GNP has increased rapidly, with an annual average rate of 13% over 18 years (through 1984/85) with a rapid increase in GNP per capita, to a figure of $840 (1986). The primary stimulus over the last decade has been diamonds, which, by greatly increasing Government revenue, facilitated very rapid expansion of Government activities, which in turn speeded private sector growth. Diamonds also contributed greatly to foreign exchange earnings. But the overall growth figure is misleading as other sectors of the economy, especially manufacturing and agriculture, have lagged seriously.

The lag in agriculture is in part, especially in recent years, the result of 6 consecutive years of drought, in some years rainfall being only half of normal. This has had disastrous effects on farming, since rainfall is marginal at best, and has caused serious losses in herds and reduction in slaughtering and thus in export of meat. Cattle raising accounts for over 80% of the total GDP of the agricultural sectors. Depletion of herds cannot be quickly offset even after rainfall returns to normal.

Secondly, the foreign trade balance and thus foreign exchange reserves have increased sharply; the exchange reserves now (1988) cover 24 months of imports. The country's exports are valued primarily in dollars, its imports in rand. As the rand has fallen relative to the dollar, and even to some extent relative to the pula, the Botswana unit of currency, a given volume of trade results in a greater positive balance. The rapid growth of diamond exports also contributed to the foreign exchange reserve. While the Government experiences some influence over the rate of exchange, occasionally making changes for protective reasons, there is no import licensing or currency control and the rate is basically a free market rate. By contrast with most African countries, foreign debt is

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relatively small; debt service amounts to only about 5% of export earnings.

Thirdly, the rate of unemployment, now estimated at 25% of the working population, remains as a serious and growing problem. Diamond production creates relatively few jobs and the manufacturing sector has seriously lagged.

The Customs Union

An important element in the picture, which affects economic development as well as Government revenues, is participation in the Customs Union with South Africa, together with Lesotho and Swaziland. There are no barriers to trade among the countries, and a common external tariff. The result is the availability of relatively cheap consumption goods in Botswana, lower cost inputs for agriculture and other activities and access to South African markets. But scarcely 10% of the exports go to South Africa. The main negative consequence is the great difficulty for Botswana to develop industry, and even some forms of agriculture, given the competition of large-volume low-cost firms in South Africa. Yet breaking away from the common market is not regarded as feasible given the long established trade and transport routes; the result would be chaos, serious shortages, and other disruptions.

TABLE I
Overall Budget position, Government of Botswana, 1980/81 – 1988/89
(000,000 pula)

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	Est. 1988/89
Consolidated funds									
Expenditures		351	299	454	622	755	1257	1436	1711
Revenues		320	370	511	756	1085	1461	1596	1711
Surplus		–12	–31	71	57	134	331	20	–
Consolidated cash flow									
Expenditures:									
Recurrent	161	199	227	270	342	428	573	689	775
Development	121	121	160	141	210	248	405	550	600
Total incl. misc.	309	341	415	460	615	719	1008	1317	1497
Revenues:									
Tax	244	227	278	441	628	835	1174	1365	1448
Non tax	25	56	67	74	132	257	303	260	284
Grants	38	40	47	48	39	41	67	69	42
Total	307	323	392	563	799	1133	1544	1694	1174
Recurrent Budget surplus	–12	–31	71	57	134	351	204	159	–
Overall surplus	–2	–19	–21	103	188	414	539	377	280

Non-tax revenue consists primarily of earnings of the Bank of Botswana and interest.

Source: Republic of Botswana, *Financial Statements, Tables and Estimates of Consolidated and Development Fund Revenues,* 1988/89, Gabarone: Government Printer, 1988.

TABLE II
Tax revenues by type of tax, 1966/67; 1980/81 – 1988/89
(000,000 pula)

	1966/67[3]	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	Est. 1987/88	Budget Est. 1988/89
Minerals	0	101	77	99	194	376	581	843	984	997
Income tax	1.62	38	42	58	79	87	94	121	134	140
Customs[1]	1.13	102	104	114	157	156	149	192	228	291
"Sales" tax[2]	0	0	0	3	8	5	6	13	15	15
Other[4]	.40	3	4	4	3	4	5	5	4	5
Total tax revenue	3.15	244	227	278	441	628	835	1174	1365	1448

1. Including excises.
2. To 1988, limited to liquor, tobacco, motor fuel.
3. Rand.
4. Death duties, property transfer taxes, licences, export duties (which yield negligible revenue).

Source: Republic of Botswana, *Financial Statements, Tables and Estimates of Consolidated and Development Fund Revenues,* 1988/89, Gabarone: Government Printer, 1988, except 1966/67: Republic of Botswana, *Annual Statement of Accounts and Estimates of Revenues and Expenditures*, Gabarone: Government Printer, 1967.

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In addition, Botswana and Zimbabwe have recently renewed a free trade agreement so goods move freely between the 2 countries without tariff barriers, though they do not have a common external tariff.

THE RELATIVE RELIANCE ON VARIOUS REVENUE SOURCES

Table I shows the overall relationship between expenditures and revenues.

The most significant features of these figures include the surplus position, both on the recurrent Budget and the overall Budget, since 1983/84, reaching a peak in 1986/87, and then declining, as since that year expenditures have risen more rapidly than revenues.

Table II provides a breakdown of the tax revenues by major type of tax, and **Table III** the revenue from each tax as a percentage of total tax revenue. Figures for 1966/67 are included for purposes of comparison. In the immediate period after independence, the income tax was the dominant source and customs was second, with no revenue from mineral taxation. In the 1980-84 period, mineral taxation, almost entirely on diamonds, became a significant source, with customs of comparable importance, and the income tax, though growing in revenue, down to about one fifth of the total. From 1984 on, this trend accelerated; since that time mineral taxation has been yielding nearly three fourths of tax revenue, followed by customs with 15 to 20%, the income tax around 10% and the new selective sales tax (actually, by usual terminology, only a group of excises), and other taxes of nominal importance. This is of course an unusual revenue pattern, rivaled only by that of major oil exporting countries.

TABLE III

Tax revenues by type of tax as percentage of total tax revenue, 1966/67; 1980/81 – 1988/89

	1966/67	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	Est. 1987/88	Budget Est. 1988/89
Minerals	0	41	34	36	44	59	69	72	72	69
Income tax	51	16	19	21	18	14	11	10	10	10
Customs	36	42	46	41	35	25	18	16	17	20
"Sales" tax	0	0	0	1	2	1	1	1	1	1
Other	13	1	1	1	1	1	1	1	neg.	neg.
Total tax revenue	100	100	100	100	100	100	100	100	100	100

Source: Republic of Botswana, *Financial Statements, Tables, and Estimates of Consolidated and Development Fund Revenues*, 1988/89, Gabarone: Government Printer, 1988, except 1966/67: Republic of Botswana, *Annual Statement of Accounts and Estimates of Revenues and Expenditures*, Gabarone: Government Printer, 1967.

MINERAL TAXATION

Diamonds represent the sole source of mineral tax revenue in recent years. It is not useful to go into detail on the taxation of diamonds. Essentially this is a tax on net earnings, based upon the Income Tax Act, but the amount determined by special agreements between the Government and the mining companies under power given to the Minister of Finance and Economic Planning to change the application of the tax as he wishes. The top rate of the company tax applies but the actual effective rate is reduced by liberal capital allowances. A portion of the revenue is technically royalty but is reported as tax revenue and the agreements relate to the overall combined burden of the 2 elements.

In addition the Government shares in the profit as owner of half of the shares; the other half is owned by the DeBeers interests. Thus in total the Government gets much more than half the profits, an arrangement regarded as highly favourable to the country. Diamond production is capital intensive; the ground is dug by power equipment, layer by layer, and the rock crushed to obtain the diamonds.

The same type of tax arrangement applies to the copper-nickel mining operations; the Government is part owner, the remainder held by British and other outside interests (not South African). Low copper prices have resulted in the failure to yield any Government revenue thus far but with the improvement in world copper prices, some should be forthcoming.

INCOME TAXATION

While the income of tax currently yields no more than 10% of total tax revenue, it is almost certain to grow in importance as the economy develops. In pre-independence days, the tax applied only to expatriates. The present tax law dates back to 1973 but there have been many changes since.

Structure of the tax

A single income tax act applies to both individuals and companies, although the rates differ. Major changes have occurred within the past year. The company tax applies at a 40% rate to company profits, after deducting dividends paid to resident holders, the dividends being subject to the individual income tax. Thus double taxation of dividend income is avoided. An 18%

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withholding tax applies to dividends paid to foreign shareholders. There are very few incentives features, avoided as a matter of policy, although the Minister has the power to make discretionary reductions, in practice provided only to some small firms.

Individuals are subject to PAYE; most persons do not have to file returns as the amounts withheld are adjusted so far as possible to ensure appropriate payment. Usually filing is necessary only if the person has significant non-wage income. Husband and wife are treated as separate taxpayers if the spouse has more than nominal taxable income. The 2 principal tax tables applying to resident individuals are reproduced in **Table IV**. The tax is considerably greater on each person if both have taxable income, although the maximum rate, 50%, is the same. Separate tables are provided for non-resident persons and for estates and trusts. In both instances, the first 5000 P of income is exempt (the equivalent of roughly US$ 2500 at October 1988 exchange rates).[1]

In 1987, previous allowances, for education, medical care, etc., were removed and the current simplifi rate tables provided. The only deductions allowe (called claims) are interest on home loans, and con tributions to old age retirement pension systems greatly increased in 1987/88 year to encourage persons to save for old age. There are no allowances for dependents.

Taxation of agriculture

Technically farmers are subject to the tax. But given the exemptions and the various cost allowances, virtually no farmers pay tax – most small ones because of the exemption allowance, some by simple failure to file, the larger ones by taking full advantage of the income-related deductions. This is particularly true of the cattle raisers. Given the exemption, a producer would not be likely to be liable for tax unless the herd was from 350 to 500 head. But the chief element reduc-

1. One pula is equal to $ 0.502 as of 1 October 1988.

TABLE IV
Principal income tax tables, Botswana, 1988

Rate of tax 1987/88 and subsequent tax years

[TABLE A]

Taxable income (pula) More than	but not exceeding	Tax (pula)
0	5000	0
5000	6000	5% of every 1 P
6000	8000	50 + 10% of excess over 6000
8000	11000	250 + 15% of excess over 8000
11000	15000	700 + 20% of excess over 11000
15000	20000	1500 + 25% of excess over 15000
20000	25000	2750 + 30% of excess over 20000
25000	30000	4250 + 35% of excess over 25000
30000	35000	6000 + 40% of excess over 30000
35000	40000	8000 + 45% of excess over 35000
Over	40000	10250 + 50% of excess over 40000

Table A applies to
(1) a resident unmarried individual, and
(2) a resident married individual whose spouse has taxable income.

[TABLE B]

Taxable income (pula) More than	but not exceeding	Tax (pula)
0	5000	0
5000	8000	5% of every 1 P
8000	11000	150 + 10% of excess over 8000
11000	15000	450 + 15% of excess over 11000
15000	19000	1050 + 20% of excess over 15000
19000	24000	1850 + 25% of excess over 19000
24000	29000	3100 + 30% of excess over 24000
29000	34000	4600 + 35% of excess over 29000
34000	39000	6350 + 40% of excess over 34000
39000	44000	8350 + 45% of excess over 39000
Over	44000	10600 + 50% of excess over 44000

Table B applies to a resident married individual whose spouse does not have taxable income and certain other persons.

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ing tax liability for the large producers is their privilege of using standard value figures for the receipts from their sales of cattle, figures that are far below, often no more than a quarter of, the actual selling price. Yet the cattle producers can deduct all expenses, including the actual cost of the cattle.

To reach the income from beef production, a complex tax system is applied to the Botswana Meat Commission, a Government agency that slaughters, processes and exports most of the beef produced. The tax is technically an income tax, at the standard 40% rate. But the base to which the rate is applied is not net earnings in the usual sense but net sales – receipts from sales less transport and other marketing selling costs, but not net of the cost of the cattle nor all processing costs. Thus the levy approaches being a sales tax. But this base is not fully subject to the tax rate; 10% of the first 3 million P sales, 20% of the next 3 million P, 30% of the third 3 million P and one third of amounts in excess constitute the base to which the 40% tax is applied. What is left covers the operating costs of the Meat Commission and the remainder is distributed at the end of the year to the cattle producers. Thus in effect the tax primarily reduces the amounts received by the cattle raisers and operates much like an export tax.[2] The Government gains substantial revenue from this levy but in turn makes substantial expenditures to aid the beef industry, up to 20 million P in recent years, particularly because of the drought. There is considerable belief that the Government cannot get much more revenue out of the beef industry, but could do so in better ways, more directly related to the earning of the cattle raisers.

Botswana has only 2 double taxation agreements, with South Africa and the United Kingdom; the lack of more treaties may be a significant factor in lessening outside investment.

Operation of the income tax

The tax is administered by the Department of Taxes, headed by the Commissioner of Taxes, currently an expatriate with long experience in tax administration in developing countries. The total staff is 141, with 7 to be added in the current year. One hundred of these are classed in the general administrative staff group, primarily consisting of collectors, assessors and senior administrative assistants. There are 24 inspectors of taxes in the various ranks. There are 11 expatriates in senior positions, in addition to the director. Most of the staff are recruited from secondary school graduates, who gain their accounting certificates and then are given an intensive training programme. Some university graduates are recruited, about 15 since 1972, but all but 2 have left for the private sector or other Government agencies where pay and chances for advancement are better. Salaries are regarded as adequate in the lower levels but not in the higher levels, and the number of staff reasonably adequate, but not for all projects the department would like to undertake.

There are about 4,000 companies on the tax rolls, and roughly 3,500 employers collecting and remitting PAYE, plus about 1000 additional where the directors are the only employees. There are about 60,000 employees subject to PAYE. Collection is not regarded as a major problem. In the event of failure to pay, the collector may attach payments to the delinquent taxpayer but he virtually never seeks to seize property. Most of the PAYE firms are companies; no attempt is made to apply PAYE to household employees most of whom would not be subject to tax anyway. Separate accounts are not maintained for each employee although the employer reports annually the amounts withheld from each employee. Amounts withheld are paid monthly to the Department.

About 18,000 individuals are assessed annually. As noted, most persons subject to PAYE do not have to file. There is no self-assessment. The assessing officers are secondary school graduates who have received a 9-month training programme.

District offices are located in Francistown and Selebe-Phiwke (the latter for PAYE only). Collections are now computerized and the hope is that by 1989 assessments will also be on the computer. A small investigation branch, consisting now of 3 expatriates, investigates cases where fraud is suspected. Local persons are now being trained for the work.

There are several obvious inadequacies in the operation, recognized by the Department and stressed by higher officials in the Ministry:

1. No real audit programme of the type necessary for effective income tax administration. The programme is as successful as it is because of the importance of PAYE and the tendency of large firms to pay on a reasonable basis.
2. Lack of expertise to check the returns and accounts of traders.
3. Inability to obtain and retain well qualified personnel.
4. The inability to check carefully on whether or not employees should be filing returns because of income not subject to PAYE.
5. Some problems with transfer payments, primarily involving South African-owned chain stores.

CUSTOMS, EXCISES, AND THE SALES TAX

As noted, the indirect taxes are second in revenue only to mineral taxation, exceeding the income tax. There are 3 elements: the customs duties, the excises and the levy called a sales tax, which by common terminology consists of a second set of "excises" applying to imports as well as domestic production.

Customs duties and excises

Botswana entered the Southern African Customs Union in 1969. The dominant partner in the union is

2. There is also a very low export tax on export of cattle, 2 P per head.

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of course South Africa. The customs union has a single external tariff, with no tariffs on shipments among the countries. Technically Botswana issues its own tariff, but it is identical to that of South Africa. The tariff has important protective elements to aid in the development of industry. As a consequence, for example, virtually all vehicles sold in the countries are assembled in South Africa with a substantial South African content. The tariff is also an important source of revenue for all 4 countries. In 1988, South Africa added a surtax to the tariff, the effects of which on prices is feared in Botswana.

The duty is collected primarily at the first point of entry, which for most imports from abroad is a South African port. The revenue goes into a common pool, which is allocated among the 4 countries on the basis of a formula, one more favourable to the 3 small partners than to South Africa – so much so that the recent Margo Commission in South Africa recommended that the formula be changed to give South Africa a larger share.

There are some exceptions to the rule of collection at South African ports. Upon the request of the firm involved, the goods can be shipped in bond, by rail or road, to Botswana and duty collected by Botswana Customs and Excise. When goods have been cleared in South Africa, Botswana checks the South African bill of entry at the border. On imports from Zimbabwe, customs clearance is made at the border on road traffic, in Gabarone on rail traffic. The same rule is applied on imports from Zambia. Imports from Zimbabwe of Zimbabwe origin are not subject to duty because of the free trade agreement, but goods of other origins are subject. The increasing volume of imports by air is cleared at the airport.

The excise duties are collected, on goods produced in South Africa, at the factory, by South African Customs and Excise, and the revenue allocated to the common pool, as are customs duties.

The coverage of excises is typical: wine, beer, distilled spirits, cigarettes, and other tobacco projects, and motor fuel. All have specific rates.

The "sales tax"

When South Africa unilaterally imposed a retail sales tax in 1969, it indicated to the other 3 countries that they were free to do so as well. While goods exported from South Africa to Botswana are not subject to the South African sales tax, their prices may contain some elements of South Africa's tax because of cascading of tax on inputs. South Africa is moving toward a value added tax which should eliminate the cascading.

Botswana did not have a sales tax until 1981 when it imposed what is called a sales tax, but is limited to approximately the same items as covered by the excises; the difference is that the sales tax applies to goods imported from South Africa and other countries as well as to domestic production and the rates are set by Botswana legislation. The rates are specific and vary by commodity. The major items, the rates and the revenue are shown in **Table V**.

The tax was introduced in 1982 as a means of getting more revenue from indirect taxes, given the inability to unilaterally adjust customs duties, in the fear of an overall Budget deficit. This fear was not realized, but the tax has been kept with the intention of ultimately expanding it to a general sales levy. Such a tax is not needed for revenue purposes at present but the plan is based upon 3 considerations: a possible breakdown in the customs union, a possible fall in diamond prices and the end of special concessions from the EEC.

Plans for broadening the sales tax

In the 1987/88 Budget message, the Government indicated that the sales tax would be broadened, with a general 5% rate and a 10% figure on luxuries to be effective in 1988. In the 1988/89 Budget message, the Minister of Finance and Development Planning indicated that the "broadening of the sales tax base will be done gradually over a number of years, as we develop the ability to administer the tax effectively, and as revenue requirement dictate".[3] The Minister also indicated that in 1988 selected luxury goods, primarily consumer durables, would be subjected to a 10% tax, raising additional annual revenue of 3.5 million P. The Government is reluctant to move quickly to a more general levy primarily because of need for Customs and Excise to develop means to administer it effectively.

Meanwhile, the staff of Customs and Excise is being given additional staff and experiences of other countries are being studied. The Kenya tax on importation and manufacture with some value added tax elements is serving as the primary model. The Zimbabwe retail sales is not considered suitable for the conditions of Botswana from an operational standpoint; the same is true of a general value added tax.

The present combined excise and sales tax rates are low by comparison with many countries. For petrol (gasoline) for example, the combined rate is about 18 thebe per litre, selling at 72.6 thebe or about 24%; the tax on diesel fuel is even lower. For several years diesel fuel was freed of tax because of the importance for road transport but the tax was restored in 1986. The railway system complains of heavy subsidy to road transport because of the low fuel taxes.

Operation of the sales tax

A high percentage of the tax is collected at importation since most of the goods subject are produced in South Africa. For the domestic brewery, the principal domestic producer subject to tax, tax is paid on a monthly basis, as the brewery is highly computerized; Customs and Excise personnel are not stationed in the plant.

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3. Republic of Botswana, *Budget Speech* 1988 at 24.

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TABLE V
Rates and yield of the Botswana sales tax, 1988

Goods	Rate	Revenues, 000 pula		
	Thebe per litre:	1986/87	Est. 1987/88	% of total tax revenue 1987/88
Petrol (gasoline)	8	5,966	6,586	0.48
Diesel fuel[1]	5	3,732	4,105	0.30
Traditional beer	1.6	792	1,238	0.09
Regular beer	8.9	1,750	1,926	0.14
Wine:				
natural	14.4	141	155	0.02
fortified	18.4			
sparkling	41.6	157	173	0.02
Other fermented beverages	12.8	27	272	neg.
Spirits	Pula per litre:			
Whiskey	1.04	703	774	0.06
Brandy	0.90			
Liqueurs	0.96			
Other	0.92			
				1.11

1. Except that for farmers.

The 1988/89 Budget estimate figures are identical with the 1987/88 estimates.

Sources: *Sales Tax Act*, 1982; *Sales Tax Regulations*, 1984, and subsequent amendments; *Financial Statements, Tables, and Estimates of Consolidated and Development Fund Revenues, 1988/89*, Gabarone: Government Printer, 1988, at 20.

1 pula = 100 thebe.

The Department of Customs and Excise currently has a staff of about 230. In addition to the Director of Customs, relatively new in the position, not having risen through the customs ranks, a deputy director and an assistant director, there is a general administrative staff of 113, 30 being customs and excise officers of various ranks, 83 customs assistants. There is a professional staff of 3, a preventive staff of 34 and a secretarial group. Some university graduates are hired for technical positions; for the customs officer ranks, secondary school graduates are hired and given an extensive training programme. Preventive staff typically have only a junior school certificate. It is reported that salary schedules are adequate and that prestige of the service is high.

The decision has been made that the general sales tax will be administered by Customs and Excise, not by the Tax Department; superficial contact with the 2 agencies suggest that this is the appropriate decision under the circumstances – unlike the situation in many countries. Under the planned general sales tax at the import and manufacturing level it is estimated that there will be between 2000 and 3000 taxpaying firms.

Smuggling is not regarded a major problem, except for a limited amount from Zambia; were the customs union to be eliminated, the potential for smuggling would be very great. The sales tax will of course increase the incentive for smuggling.

LOCAL TAXES

The principal local tax, confined to the urban areas, is the property rate, based upon capital value, applied equally to land and improvements, unlike the common pattern in east and central Africa of taxing land more heavily. The tax is locally collected. There is no property tax in rural areas as the land is communally owned. In 1987 the Government eliminated the local "personal" tax, an outgrowth of the colonial hut taxes which had become a mini-income tax and not at all well-collected. The revenue was replaced by Central Government grants. The Government also eliminated the local tax on beer, replacing the latter by grants from the Botswana Government tax on traditional beer. In general the Central Government makes up the shortfall of local revenue by grants.

CONCLUSION

Botswana enjoys a greater tax base relative to revenue needs than most African countries primarily because of the important diamond production and export. But as any country primarily dependent on one product for foreign exchange and Government revenue, it suffers from the potential hazard of decline in output of the product or in world market prices and from the effect of the export of diamonds on the exchange rate and

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thus the difficulty of increasing other exports. It also has the advantage of a ready market for its other main export, beef, at prices well above world levels. Participation in the Southern African Customs Union is beneficial in terms of customs and excise collection and minimization of smuggling but is regarded as objectionable on political grounds, as is the high dependence on South Africa for imports and for export routes. Break up of the customs union would create serious disruption of trade and revenue, certainly in the short run. Over time, the hope is to increase trade with the other SADCC countries, and lessen dependence on South Africa. Meanwhile a general sales tax is being developed to lessen the danger of either loss in diamond revenue or break up of the customs union. The major problem the country faces is unemployment, and tax changes offer little potential for increasing employment.

A NOTE ON THE ZIMBABWE SALES TAX

As noted, Botswana has rejected the type of retail sales tax used in Zimbabwe on operational grounds. This tax, a purely retail sales tax, was first imposed in 1963. The coverage is broad, with exemptions limited to basic food items, medicine, and some transport items, and some services are covered. In recent years the basic rate has been 12½%, with a 20% rate on consumer durables. In 1985-86, a detailed review of the entire tax structure, including the sales tax, was made by a commission headed by Raja Chelliah.[4] The report recommended retention of the retail form of sales tax, but some change in exemptions, shift to a single rate, and increase in the exemption of small firms. The Government has followed this last recommendation, raising the figure from Z$ 50,000 to 100,000, and plans to go to 250,000.[5] Sales to exempt firms by suppliers are of course taxed; only the retail margin escapes tax.[6] In the opinion of the Tax Department and the Chelliah Commission the tax works well; revenues have been outrunning expectations; and no serious problems are encountered. There are currently about 10,000 registered firms. But Zimbabwe is a much more urbanized country than Botswana and the latter is probably justified in rejecting this approach.

4. *Report of the Commission of Enquiry into Taxation,* to the President, Harare: Government Printer, 1 April 1986.
5. As of October 1988, $Z 1 = $US 0.52.
6. Unlike United States practice, retailers must include the tax in the price, although wholesalers may show it as a separate item. Capital equipment is not exempt from tax except for refund on building materials for manufacturing plants in specified small towns. Administration is in the hands of the Tax Department, not Customs and Excise, though the latter collects the tax at importation.

Conference Diary

JANUARY 1989

Belastingvereenvoudiging & Ondernemen. Amsterdam, 9-10 January (Dutch):
I.I.R. b.v., World Trade Center, Strawinskylaan 331, 1077 XX Amsterdam, The Netherlands.

Fundamental Elements of U.S. Federal Taxation. Arundel, 9-14 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S. Taxation of Corporate Reorganizations. Arundel, 9-14 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S./International Taxation – Tax Strategies for Cross Border Activities. Arundel, 9-14 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

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FEBRUARY 1989

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The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Nehterlands.

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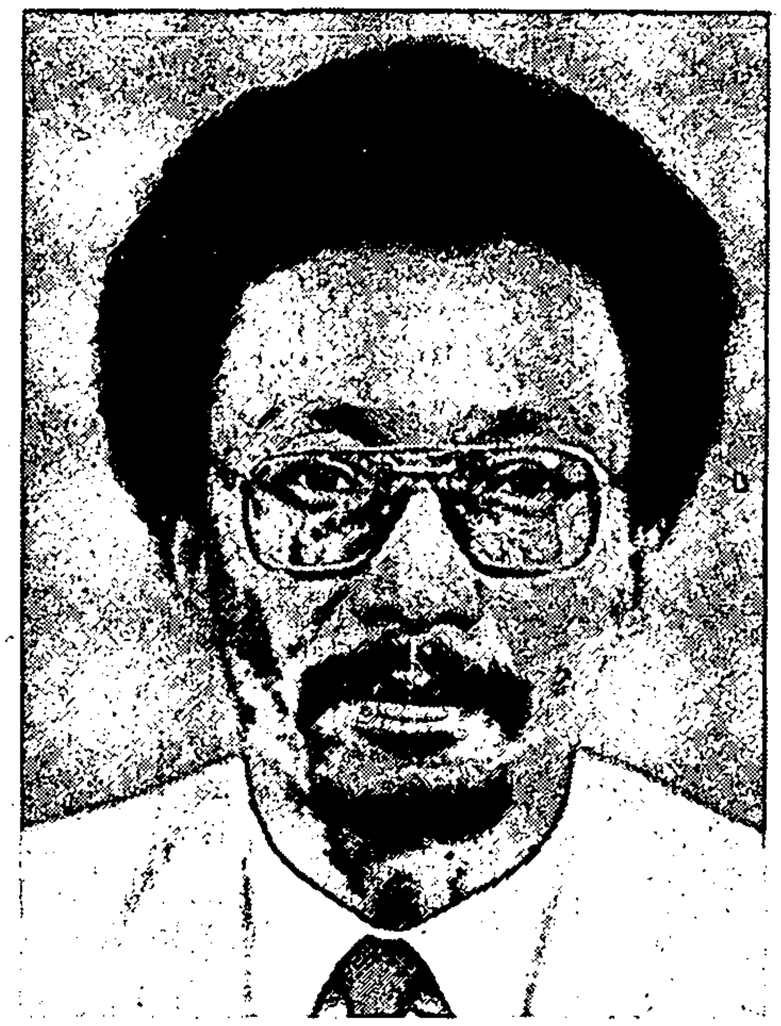
Direct Taxation in the Sudan

By Abdin Ahmed Salama



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I. HISTORIC DEVELOPMENT

Until 1955 direct taxes in the Sudan were defined as taxes levied on traditional activities carried out in rural areas (e.g. the date, land, Ushur, poll, animal and tribute taxes).[1] Other taxes which were considered direct taxes by the Sudan Government were traders' licences, business profits tax, house tax, rent from Government land and properties and road tax. This administrative classification applies today; all taxes collected by the Department of Taxation are considered direct taxes. Stamp duty and sales taxes are considered direct taxes for the sole reason they are collected by the Department of Taxation.[2] This article surveys Sudan's taxes on personal income, companies, estate or inheritance, capital gains and net wealth by comparing the Income Tax Laws of 1971 and 1986.

Sudan's experience with direct taxation is limited. The only long-standing direct tax is the 1913 business profits tax (BPT) imposed primarily on traders. No tax was levied on personal income until 1964, i.e. 8 years after independence.[3] Since 1964 major developments have taken place in designing and implementing a modern income tax system. In 1964 a tax on personal income (PIT) was imposed on salaries and wages and a land rent tax was imposed on income from rented property. In 1967 a move was made to implement a global system of taxation by consolidating income from salaries and wages, business profits and land rent.

The 1971 Income Tax Law sought to close the many loopholes which allowed for tax evasion or delinquency. A capital gains tax was imposed in 1974 to increase the role of direct taxation. Profits accruing from the sale of land and buildings were subject to the tax. In 1976, a development tax on income was imposed on all individuals and companies in order to enhance and recoup revenue from projects which were exempt under the Encouragement of Investment Act. As of 1980 all persons holding trading licences were required to have tax cards and all Government units dealing with taxpayers were instructed to register their transactions.

The number of Sudanese emigrating to the rich neighbouring oil countries increased. The Income Tax Law of 1971 was amended in 1981 to allow imposition of an income tax on non-resident Sudanese, i.e. Sudanese working abroad (SWA). The tax was imposed at the rate of 10% of their income. The tax administration encountered problematic difficulties with the tax on SWA so the administration introduced a number of changes between 1982 and 1985. In 1982, for example, the tax was imposed on the basis of occupation in the host country. A fixed rate was imposed on each occupation group, i.e. workers, civil servants, professionals and businessmen. Since the rate was set in dollars and paid in Sudanese pounds, the tax rate changed continuously. Application of the tax created compliance difficulties with respect to individuals whose income could not be easily traced and for whom no PAYE system was feasible. It was then thought that certain documents (i.e.issuance and renewal of passports and exit visas) should only be issued upon presentation of a tax clearance certificate. After the revolution in April 1985, the tax was replaced by a compulsory national contribution.

1. Contributions from native administration and the cultivation taxes were added to the above taxes.
2. This definition, of course, contradicts the well-known definition of direct taxation.
3. This phenomenon may be attributed to the fact that Sudan was conquered by the British and the Egyptians following the takeover of the Mahdi. One of the main factors contributing to the success of the Mahdi was the severe taxes imposed by the Turkish Empire. To prevent uprisings the British decided to levy low direct taxes. Earl Cromer stated: "Low direct taxation should be the keystone of the political arch, it brings tranquillity in its strain" and "in the assessment and collection of taxes no innovation based on Western ideas should be introduced unless its introduction is unavoidable" (see Z.M. Kubinski, *Direct Taxation in Export Economy: A case study of the Republic of the Sudan*, Public Finance, Vol. 14 (1959) at 218). For a brief description of Sudan's history, see Suliman; Prof. Ali Ahmed, "Experience with *Zakat*", 42 *Bulletin for International Fiscal Documentation* 1 (1988) at 34 (hereinafter referred to as "Suliman").

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A committee to reform the tax system was established in 1983. The committee was composed of Sudanese experts and representatives of concerned groups and governmental units and was entrusted with the task of developing reform proposals to improve administration as well as to enable the direct tax system to achieve economic equity. The committee issued an extensive report containing recommendations, some of which were adopted in the 1986 Income Tax Law. Those recommendations included the following:

(1) income accruing to a resident Sudanese from outside Sudan was to be subject to tax even if the income was not transferred to Sudan;
(2) imposition of agricultural income tax on mechanized farms;
(3) imposition of a tax on tenants of irrigated projects;
(4) deduction of interest and investment income;
(5) a wide range of withholding measures; and
(6) increasing the exemption level to 1,500 LS.

In September 1984, the then President (President Nimeiri) abolished all taxes at the local and central level (with the exception of import duties)[4] and replaced these taxes by issuing a decree imposing the *Zakat a*nd Taxation Act 1984.[5] *Zakat* was imposed at a flat rate of 2½% on financial holdings, wages and trading stock and it was levied in kind with respect to agriculture and livestock. The new Act also imposed a 10% tax on investment and development on all capital invested in the Sudan.

The *Zakat* and Taxation Act 1984 faced strong resistance from both foreign and domestic investors. The Government soon realized it would experience huge deficits[6], so the Act was amended in 1984 to implement the social security tax which was imposed on partnerships and companies at rates ranging between 20 and 30%.[7] The tax was also imposed on the income of individuals but it provided for a large exemption level of 6,000 LS annually, tax rates progressing to a maximum of 25% on income up to 45,000 LS per annum, and 30% for additional income. The amended Act was simple in form and included no details on how the tax should be imposed nor did it contain any details that normally are found in tax legislation. The Act remained operative until a new income tax law bill was presented in 1986. The 1986 Income Tax Law remained a provisional Act until 1987 when it was passed by Parliament. The 1986 Income Tax Law was effective retrospectively from the 1985 assessment year.

4. A total of 17 taxes were abolished, including income tax, capital gains tax and taxes collected by the local governments in lieu of income taxes. See Suliman at 35.
5. The Act also established a *Zakat* and Tax administration to work directly with the President. *Zakat* is a religious levy and one of the cornerstones of Islam. For a discussion of *Zakat,* see Suliman.
6. The limited revenue from *Zakat* derives from the fact that the tax could only be used to help the needy and the poor.
7. This was essentially a re-introduction of the BPT but with lower rates.
8. This reflects the prejudice against the salaried class at that time and the current prejudice against banks. Salaries are favourably treated under the 1986 Income Tax Law.

II. COMPARISON OF THE 1971 AND 1986 TAX LAWS

A. In general

Following the recommendations of specialized committees, the 1986 Income Tax Law introduced various changes in the 1971 Law. Although the 1986 Law departs from its predecessor in many areas, only the most significant changes are examined in this article.

1. Schedular structure

The schedular structure of the income tax was maintained as was the section providing for global assessment by combining income from business profits, land rent and personal income. Two sections, however, depart from the schedular system. Under Sec. 29, income from land rent and business profits is combined and taxed under one schedule. Pursuant to Sec. 30, income from personal income, land rent and/or business profits is combined and taxed under one schedule. If income from land rent and/or business profits is less than one quarter of personal income, the income from salary is taxed according to the schedule applicable to personal income. However, if income from land rents and/or business profits exceeds one quarter of personal income, that income is subject to the BPT and land rent schedule with no exemption level while personal income is subject to the schedule on personal income.

The 1986 Law retained the progressive nature of the income tax with the highest progressive rate applicable to the profits of banks reaching 70%. The highest rate under the 1971 Law applied to salaries.[8]

2. Deductions

Under the 1971 Law the wages and salaries of full-time directors who held more than 10% of the company's shares could not be deducted by the company. The 1986 Law amended this provision to allow a deduction to be taken according to wages normally paid to similar directors but the deduction is limited to the wages and salaries of 2 directors.

Sec. 18(1)(b) allows professionals to deduct 15% as professional depreciation; this deduction was not available under the 1971 Law.

3. Exemptions

A major departure point in the new Law concerns the issuance of exemptions. Under Sec. 17(2)(a) of the 1971 Law, the Council of Ministers had authority to exempt any income or class of income from tax. New Sec. 17(2)(a) allows the Minister of Finance, upon a recommendation of the Director of Taxation, to exempt any income from tax.

The 1986 Law does not exempt interest income paid by banks or the post office although this income was exempt under the previous legislation. Interest paid on foreign loans is exempt from taxable business profits.

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Unlike the 1971 Law, the 1986 Law exempts certain individuals from tax, i.e. individuals who are employed in the public sector and reach the age of 50, individuals who work for 25 years, individuals who are entitled to a pension but do not claim it and individuals who are employed in the private sector until they reach the age of 60.

The 1971 Law only allowed exemptions which were expressly set forth in the legislation or which were approved by the body authorized to issue exemptions. Sec. 17(1) of the new Law incorporates all exemptions from income tax under other prevailing laws in order to safeguard exemptions already granted, i.e. tax-free allowances paid to the police force, the attorney general, cooperatives and others. The new provision will also protect other groups which enjoyed exemptions from income tax under certain laws.

4. Accounts

The 1986 Law appears more lenient with respect to audited accounts:

(a) Under Sec. 20(e) self-employed businessmen are offered an exemption of 1,200 LS or 15% of their profits, whichever is greater, as a personal allowance. In the case of professionals, the allowance is 20% of their profits or 2,400 LS, whichever is greater. The 1971 Law allowed a personal allowance only if true audited accounts were submitted whereas the 1986 Law grants the allowance if true audited accounts are submitted *or* if income tax returns are submitted in accordance with Sec. 38.[9]

(b) Under Sec. 38 donations may be deducted. Donations in cash may be deducted in full but donations in kind may not exceed 10% of profits or 10,000 LS, whichever is greater. Audited accounts must be presented for donations in kind while cash donations may be deducted if an income tax return is accepted by the Director of Taxation.

(c) Under the 1971 Law losses could be carried forward for 5 years only if audited accounts were submitted. Under Sec. 21(d)(ii) and (e) of the new law the Director of Taxation has authority to accept such losses and they can be carried forward if compelling circumstances prevent the taxpayer from presenting such accounts or if the losses occurred during a tax base period in which the taxpayer did not present audited accounts but did submit an income tax return in accordance with Sec. 38.

The 1986 Law contains some incentives as well as obligations to ensure that proper accounts or audited accounts are maintained:

- Sec. 39(3)(a) requires businesses which have a capital of 30,000 LS or turnover exceeding 100,000 LS to maintain books of account that reflect the volume of activities subject to the tax. The following books must be kept: receipt and payment accounts, ledger accounts and inventory accounts and these books should be authenticated before use by the Tax Department. Sec. 40(i) of the 1971 Law did not impose any such requirement.[10]
- In case of assessment of the land rent tax, Sec. 25(1)(c) of the 1986 Law allows all maintenance expenditures to be deducted if audited accounts are presented. Sec. 25(c)(ii) of the 1971 Law allowed only a 25% deduction for maintenance expenses if audited accounts were submitted.
- Unlike the 1971 Law, Sec 47(3)(c) of the new Law makes it more difficult for the Director of Taxation to reject audited accounts because the Director must explain his reasons for rejecting an audited account.

5. Collection and enforcement

The 1986 Law includes some provisions to close loopholes which diminished the efficacy of the tax laws:

- Under Sec. 42, the Director of Taxation is authorized to enter places of business or estate during working hours or during any appropriate time to request information or explanations which ensure implementation of the tax laws.
- Sec. 69(2) grants the Director of Taxation the authority to delegate to anyone the power to enforce an administrative distraint by entering the taxpayer's property during work hours to collect the tax due. The corollary section in the 1971 Law only allowed this procedure to be carried out during the daytime.
- Sec. 69(4) grants authority to the Director of Taxation to distrain bank accounts of delinquent taxpayers and authorizes the Director to withdraw from those accounts a sum equal to the amount of tax due.[11]
- The wages and salaries withholding tax under the 1971 Law was extended. Sec. 65 requires the following units and enterprises to withhold tax:[12]
  (i) all Government units, central, local or regional councils, public corporations, cooperatives, crop markets, companies, Government factories and private factories must withhold a percentage of the tax when paying persons subject to the tax sums of money in lieu of purchases of goods or services;
  (ii) the Customs Department must deduct a specified percentage from all imports or exports;[13]
  (iii) all private hospital payments to doctors;
  (iv) courts and registration administrations must deduct a percentage from lawyers who present cases;

9. Art. 38 authorizes the Director of Taxation to ask all persons subject to the tax to present an income tax return for the previous base period or any period for which the person is subject to the tax. The return must be submitted within 2 months after the end of the base period.
10. Subsection (2), however, authorized the Director to request the taxpayer to present necessary books of account.
11. This procedure, however, is subject to the approval of the Minister of Finance.
12. The percentage of tax to be withheld will be determined by the Minister.
13. The only exclusion applies to imported raw materials and approval of the Minister must be obtained.

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(v) private sector slaughterhouses must deduct a fixed amount on the account of the BPT along with the fees required for slaughtering;
(vi) traffic authorities may not issue automobile registration or renewals of registration unless at least part of the tax is collected; and
(vii) all commercial banks and investment companies must deduct a specified percentage out of the yield of the investment certificates.

Units deducting the sums must credit the amount to the Tax Department within a month of collection. All necessary documents must be filed with the amounts submitted. Receipts should be issued to payers of the tax and these amounts will be deducted from the tax when the taxpayer presents audited accounts or income declarations prepared according to Sec. 38. The taxpayer should also present documents evidencing payments withheld on account of the tax by the relevant governmental unit.

- Sec. 70 of the new Law adopts the 1976 amendment to the 1971 Law which introduced the tax clearance certificate (TCC) but it includes 2 new situations in which a TCC should be presented, i.e. registration/renewal and transfer of transport vehicles.
- Sec. 82 of the new Law adopts the 1980 amendment to the 1971 Law requiring tax cards. It is obligatory for all governmental units dealing with persons who are subject to Sec. 70 to request presentation of a valid tax card.[14]

B. Tax rates under the 1986 Law

A higher minimum exemption is granted, reflecting to some extent the erosion of monetary holdings due to high inflation rates.[15]

1. Business profits and land rent

Income from business and land rent are subject to a separate schedule. The exemption level under the 1986 Law starts at 1,500 LS; under the 1971 Law the exemption amounted only to 170 LS.[16]

2. Tax rate on companies

The 1986 Law introduced a number of changes in the rate structure on companies as compared to the 1971 Law. All private and public companies are taxed under one schedule with the rate progressing until it reaches 60% on profits which exceed 1 million LS. The rates differed under the 1971 Law depending upon whether a company was private or public and the highest rate was 60%. The new Law differentiates between companies operating in different sectors of the economy. In the case of insurance companies, profits exceeding 1 million LS are subject to 65% tax, and bank profits exceeding 3 million LS are subject to 70%. The 1971 Law did not contain any such differentiation.

3. Tax rates on personal income

The personal income tax schedule of the 1986 Law does not distinguish between residents and non-residents with respect to tax rates. However, there is no minimum exemption for non-residents. The exemption level is set at 3,000 LS for residents (170 LS in 1971), but as explained above the exemption has undergone many changes. The highest tax rate (40%) applies to income exceeding 18,000 LS. Under the 1971 Law income exceeding 70,000 LS was subject to tax at 80%.

C. Tax administration

This section highlights some important issues related to tax administration, i.e. assessment of tax, income tax returns, appeals, tax collection and tax evasion.

1. Assessment of tax

Under Sec. 48(5) of the 1971 Law, the Director of Taxation could accept an income tax return and proceed to assess the taxpayer accordingly. Alternatively, if the Director had reasonable cause to believe that the return did not reflect a true and correct statement of the taxpayer's income, he could impose an assessment according to his best judgement. Sec. 47 of the new Law adopts the same approach but adds a provision requiring the Director to explain the reasons for deciding to reject an income tax return.[17] Sec. 47 also authorizes the Director of Taxation to form assessment committees to assist him in making assessments.[18]

Before 1968 tax assessments were the responsibility of local tax boards but under the 1986 Law the power of these boards was reduced and in 1971 they were abolished altogether due to a long-standing conflict between the local tax authorities and tax officials in the central Government. Two lists of taxpayers were maintained under the old system, i.e. the Minister's list and the local list. The Minister's list included taxpayers whose profits exceeded 1,000 LS. Taxpayers on the local list were taxed by the local Government which collected the tax as an agent of the Ministry of Finance. Competition between the 2 authorities developed and it was alleged that local Government authorities kept assessments low to keep most of the traders on their list.

Assessment may take 2 forms under existing legislation:

(i) an assessment made on the basis of income tax

14. Private sector enterprises must adhere to the same procedure.
15. No real adjustment was made for purposes of comparing the real tax rates in the old and new laws.
16. In 1966, the exemption level was reduced from 1350 LS to 300 LS and further reduced to 170 LS in 1971. In an attempt to achieve vertical equity, the exemption level between married and single persons was differentiated in 1974; the exemption level for single persons was 200 LS and for married persons, 300 LS. This was repealed in 1975 because the tax administration disfavoured the exemption and the numerous administrative problems deriving from its application.
17. The tax department may issue summary assessments according to the best of its judgement. Neither law, however, explains how assessments should be made. The entire procedure is left to the discretion of the tax administration.
18. These committees only have consultative powers.

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returns which are supported by audited accounts;
(ii) if a proper return or audited account is not presented, the tax department may make a summary assessment.

Certain factors guide the tax authorities when making summary assessments. For example, the external outlook of the business premises and their site, the volume of operations according to books of account, the rent paid by the business for the premises, the number of employees and comparison with businesses conducting similar activities. The tax authorities also use information which it obtains from the Customs and Excise Duty Department as well as information obtained from local authorities.

D. Tax returns

Sec. 39 of the 1971 Law and Sec. 38 of the 1986 Law grant authority to the Director of Taxation to require any person to provide the Director with a full and true statement of income. According to Sec. 38(3), the taxpayer must present the statement within 2 months after the end of the base period. Failure to comply or presentation of a false statement may result in a penalty.

E. Appeals

Sec. 55 of the 1971 Law and Sec. 54 of the 1986 Law stipulate that an Income Tax Board may be formed by the Minister for the purpose of hearing and determining taxpayer appeals against income tax assessments. The Board has never been formed and most appeals are heard and determined within the tax department. In fact, few taxpayers exercise their right to bring a case to court.

Under the 1971 Law appeals were neither heard nor determined unless the taxpayer paid 50% of the tax due. This clause has been changed under the new Law, i.e. according to Sec. 55(1)(c), the taxpayer may deposit the tax due or any amount required by the Director of Taxation.

III. OTHER DIRECT TAXES

A. Estate duty

There is no estate duty in the Sudan.[19]

B. Capital gains tax

Capital gains tax was first imposed in 1974 but it was repealed in 1984 along with all the other taxes (see above). The tax was re-imposed in 1986 on all transactions involving the transfer of property owned for 3 years or more. Gains deriving from the transfer of property owned for less than 3 years is considered as business profits and is subject to the income tax schedule. Capital gains tax only applies to the sale of land. The tax is levied on individuals at progressive rates ranging from 5% to 25% on capital gains of 20,000 LS; for sums exceeding that amount, the rate is 30%. A flat rate of 40% is imposed on companies.

C. Wealth tax

There is no wealth tax in the Sudan.[20]

IV. TAX COLLECTION

The tax administration faces many tax collection problems and despite the measures taken to enforce compliance through tax cards (TC) and TCCs, major obstacles stand in the way of effective tax collection, i.e. personnel is limited and other administrative shortcomings impede the work of the authorities.

V. TAX EVASION

It is believed that the level of unreported or under-reported income is very high. One form of tax evasion is income splitting among families. To prevent this practice, a 1971 regulation considered unemployed persons over 18 years of age as minors and therefore incapable of holding property. Many taxpayers instituted law suits contesting this regulation. The tax department attempted to incorporate the regulation in the 1986 Law in order to give the provision the force of law but the motion was rejected on the basis that such an amendment contradicted the common definition of minors. Consequently, "minor" is defined as a person who is under the age of 18.

The tax department included a similar provision in the 1987 Income Tax Regulations according to which unmarried girls, full-time students and the disabled over the age of 18 are considered minors. The threat of appeals to the judiciary contesting this provision remains a possibility.

Audited accounts may be prepared in such a way to evade tax by reflecting untrue losses. It was estimated by the tax department that during the years 1982-84 such accounts reflected losses for taxpayers of about 4.2 million LS. Following proper scrutiny of such accounts, it was found that the accounts should reflect profits of 9.4 million LS.

VI. CONCLUSION

Sudan's experience with direct taxation has undergone many changes in its short life. The major departure from the growth of direct taxation took place in 1984 when most direct taxes were repealed. However, the recent revival of direct taxation and implementation of the 1986 Income Tax Law resuscitates the role of direct taxation as an important source of revenue. How to achieve horizontal and vertical equity given the limited administrative resources and extensive under-reporting of income is the major challenge confronting the tax administration today. Another thorny issue which is not resolved by the 1986 legislation involves assessment of taxpayers who do not present audited accounts. The 1986 Law did, however, close a number of loopholes allowing for tax evasion and it introduced new provisions to enhance tax collection.

19. In his 1974/75 Budget speech, the Minister of Finance introduced a bill to apply estate duty but this bill was rejected.
20. A proposal to implement a wealth tax was considered in 1986 and a bill was prepared but never passed.

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VIET-NAM:

The Laws on Foreign Investment and Import/Export Taxes[1]

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On 29 December 1987 the National Assembly adopted the Viet-Namese Law on Foreign Investment and the Law on Import/Export Taxes.[2] Foreign investment in Viet-Nam is recognized as a vital ingredient to expand economic cooperation with foreign countries, achieve domestic economic development and increase exports by effectively exploiting natural resources, manpower, etc. Import/export activities must be bolstered to enhance Viet-Nam's economic climate, protect and develop production and to create revenue resources. These two laws aim to achieve these goals. The following article highlights the most salient provisions of the legislation.

I. LAW ON FOREIGN INVESTMENT

Chapter I: General provisions

In order to encourage foreign investment by foreign organizations and individuals, the State will guarantee the ownership[3] of invested capital and the rights of foreign investors. Favourable conditions and easy formalities will be established for investors in Viet-Nam (Art. 1). Art. 2 sets forth a list of pertinent definitions for purposes of the legislation; for example the following terms are defined: foreign partner, Viet-Namese partner, foreign investment, business cooperation contract, joint venture contract, reinvestment, prescribed capital and enterprise with 100% foreign-invested capital.

Certain sectors of the economy are promoted as having priority for purposes of foreign investment:
(1) major economic programmes, export production and production of import substitution products;
(2) high technology industries using skilled labour and increasing the output of existing industries;
(3) industries utilizing labour materials and natural resources;
(4) industries promoting infrastructure; and
(5) foreign exchange services, tourism, ship repair and air and sea transportation services.

Chapter II: Forms of investment

Foreign participations in Viet-Nam may be in the form of contractual ventures, joint ventures[4] or private enterprises with 100% foreign-invested capital (Art. 4). Art. 7 prescribes the capital contributions of both parties. The foreign partner's capital contribution may be in the form of foreign currency, plants, equipment, machinery and tools, spare parts or technology. The Viet-Namese partner's contribution may consist of local currency, natural resources, building materials, land, water or sea rights, buildings, services or technology. The parties may jointly agree on any other form of capital contribution.

Although no ceiling is set for the maximum contribution[5], the foreign partner's share in the venture may not be less than 30% (Art. 8). The profits and liabilities of the joint venture are to be shared by the parties in proportion to their capital contribution (Art. 10).

The partners may agree on the percentage of domestic and export sales. However, foreign currency earnings from exports and other sources must be sufficient to meet all foreign currency needs of the joint venture and ensure its normal operation (Art. 11).

According to Art. 12, the joint venture will be managed by a board of directors. A unanimous decision of the board is necessary for decisions relating to organization and operation of the joint venture, i.e. orientation of activities of the enterprise, business planning and key personnel (Art. 13). Each partner may appoint nominees to the board in proportion to its respective capital contribution. However, each partner must have at least 2 nominees on the board. The day-to-day business of the venture is to be carried out by a general director and deputy general directors who are responsible to the board. The general director or the first deputy general director must be a Viet-Namese citizen. If the enterprise is 100% foreign-owned, the board of directors may be exclusively composed of foreigners although the enterprise remains subject to Viet-Namese law. The duration of a foreign-

1. This article is based on information received from: "Summary of World Broadcasts", Part 3, Caversham Park, Reading, United Kingdom of 13 January 1988 (FE/0047/C1/1-4) and 19 January 1988 (FE/0052/C1/1-2).
2. The Law on Foreign Investment was promulgated by the Council of State on 9 January 1988 and the Law on Import/Export Taxes on 11 January 1988.
3. Ownership in Viet-Nam is divided into State or socialist ownership (Art. 18 of the Constitution), cooperative ownership (Art. 23 of the Constitution) and private ownership (Art. 27 of the Constitution).
4. The joint venture will be deemed a juridical person subject to Viet-Namese laws (Art. 6).
5. Under the 1977 Regulations on Foreign Investment, the maximum contribution was set at 49%. See Nagy, "Changes in the Tax System", 41 *Bulletin for International Fiscal Documentation* 12 (1987) at 554.

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invested enterprise is 20 years but this term may be extended in certain cases (Art. 15).

The foreign enterprise must maintain a bank account with the Bank for Foreign Trade of Viet-Nam or a branch of a foreign bank in Viet-Nam (Art. 17). The accounting methods must adhere to international principles and standards of accounting (Art. 18). The creation, operation and winding up of the enterprise must be carried out in accordance with the charter of the enterprise and Viet-Namese law (Art. 19)..

Art. 16 requires that Viet-Namese citizens be given priority in the recruitment of personnel. However, if the technical qualifications are such that Viet-Namese personnel are unavailable, expatriate personnel may be recruited. Labour contracts are to be executed setting forth the conditions of employment. Salaries and fringe benefits are to be paid in Viet-Namese currency originating from foreign currencies.[6]

Chapter III: Investment guarantee

Chapter III covers protection of the foreign investor in Viet-Nam, remittance and repatriation of profits from the enterprise and dispute resolution. Arts. 20 and 21 ensure that the Government will guarantee fair and equitable treatment to any foreign investor, and further that any invested capital, property or assets of the foreign partner will not be requisitioned or confiscated. The enterprise may not be nationalized.[7]

Arts. 23-25 deal with remittance and repatriation of capital. The foreign investor may repatriate or remit its share of the profits from the enterprise, any payments for technical services rendered, principal and interest on loans made to the enterprise, invested capital and other legal sums or assets.[8] Expatriate employees may repatriate or remit their income abroad once Viet-Namese income tax is paid in accordance with the foreign exchange control regulations in Viet-Nam. Conversion of Viet-Namese currency into foreign currency is effected at the official rate set by the State Bank of Viet-Nam (Art. 24).

If disputes between the partners cannot be resolved through mutual consultation, the dispute will be referred to the Viet-Namese economic arbitration body or other arbitration or law enforcement body as may be agreed upon by the parties (Art. 25).

Chapter IV: Rights and obligations of foreign investors

Arts. 26-35 set forth the tax rates applicable to the foreign project. The foreign-invested enterprise is liable to corporate tax from 15% to 25% of the earned profits which is half of the tax due under previous legislation.[9] A reserve fund must be established with 5% of the enterprise's after-tax profits (Art. 30).[10] Art. 27 provides that a joint venture may be eligible for a 2-year exemption from tax beginning in the first profit-making year and a 50% reduction of income tax in the succeeding 2 years. The exemption may be extended and an additional 10% reduction in tax granted in certain circumstances (Art. 28). Eligibility for the initial exemption is based on the nature and duration of the business, the scale of capital investment and the volume of exports. Losses may be carried forward and offset against the profits of the next 5 years.

Foreign investors who re-invest part of their share of the profits of the enterprise are entitled to a refund of the income tax paid on the re-invested profits (Art. 32).

Chapter V: State organ for management of foreign investment

The State Foreign Investment Board is responsible for all matters relating to foreign investment in Viet-Nam: The Board is vested with broad authority in handling the following matters:

(1) assisting and guiding the foreign investors in the negotiation and conclusion of contracts and in the establishment of 100% foreign-invested capital;
(2) approving all contracts and the creation and charter of 100% foreign-invested capital enterprises;
(3) granting preferences to enterprises;
(4) monitoring and controlling contracts and the operation of 100% foreign-invested enterprises; and
(5) monitoring the economic activities of enterprises with foreign-invested capital.

Both parties to a cooperation contract or joint venture contract must submit an application to the State Board of Foreign Investment. The application must be accompanied by the contract, the charter, a feasibility study of the project and any other documents which the Board deems necessary (Art. 37). The Board is required to render a decision on the application within 3 months from the date of receipt. If approved, the enterprise will receive an investment licence (Art. 38).

Chapter VI: Final provisions

Art. 39 provides that overseas Viet-Namese may also invest in Viet-Nam. The Council of Ministers will issue detailed provisions for implementation of the legislation (Art. 42).

II. LAW ON IMPORT/EXPORT TAXES

Chapter I: Taxable goods and taxpayers

All goods purchased from, sold to or exchanged with foreign countries are subject to import/export tax. Enterprises which are permitted to import/export goods[11] are required to pay import/export taxes upon the im-

6. Art. 31 requires the enterprise to deposit certain sums to cover social insurance for the employees of the enterprise.
7. Consequently, Art. 28 of the Constitution is inapplicable to foreign investors. Art. 28 allows the State to purchase or requisition the property of individuals or collectives when it deems such acquisition necessary for the public interest.
8. A tax between 5% and 10% of the repatriated or remitted profits must be paid. However, a tax exemption or reduction may be granted in cases where encouragement of investment is desired (Art. 33).
9. The rates for oil, gas and other valuable natural resources will be higher in accordance with international practice.
10. This fund continues until 25% of the prescribed capital of the joint venture is in the reserve.
11. All foreign trade activities are directed and controlled by the State through the intermediation of the Ministry of Foreign Trade, through 28

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port/export of goods across the Viet-Namese border (Art. 2). Goods imported/exported by foreign-owned enterprises are also subject to the provisions of this law (Art. 3).

Chapter II: Assessment

The volume of each type of good listed in the manifest forms the basis for imposing import/export tax. All taxes due must be paid in Viet-Namese dong (Art. 4).[12] The bases for computing taxes are as follows:

(1) for exported goods, the purchase price at the point of origin as specified in the contract;
(2) for imported goods, the purchase price at the point of destination (including transport and insurance charges) as specified in the contract.

Chapter III: Tax table

The State will determine the types of taxable goods and the tax tariffs applicable to each type (Art. 6). Tax tariffs are classified as minimum tariffs and universal tariffs. Minimum tariffs will be applicable to goods exported to or imported from countries which have entered into an agreement for a favoured status with respect to trade relations with Viet-Nam and in other cases as decided by the Council of Ministers. The universal tariff is applicable in all other cases (Art. 7).

Chapter IV: Tax reduction, exemption and refund

Arts. 8 and 9 specify guidelines for exemption, reduction and refund of tax. Under Art. 8, a reduction or exemption will apply in the following cases:[13]

(1) the import/export tax will be reduced for goods which are damaged or lost in the course of loading or unloading provided full proof of damage or loss is certified by the competent agencies;
(2) a tax exemption will apply for goods imported for schools or scientific research institutes, goods imported or exported on a temporary basis for display at fairs and exhibitions, goods falling under humanitarian aid programmes, goods in transit or bound for destinations other than Viet-Nam and goods made of imported or exported raw materials which are used to fill orders of foreign countries and destined for export.

A tax reduction or exemption will also apply to the goods of enterprises falling under the Foreign Investment Law.

Under Art. 9, a tax refund will be made in the following cases:

(1) on imported goods which are stored in port warehouses or loading zones and which have received permission for re-export;
(2) on goods which are not permitted to be exported or goods whose export permission has been revoked; and
(3) on goods for which export tax has been paid as per the declaration but the actual quantity of goods is less than declared.

Chapter V: Implementation

Implementation of import/export tax on commercial goods will be carried out by the Council of Ministers (Art. 10). Enterprises intending to import or export goods must file a declaration for the goods and pay the tax. Once a declaration is filed the tax collection authority must officially inform the taxpayer of the amount of tax due.[14] The tax is due within 3 days of receiving the notification (Art. 12). A taxpayer who disagrees with the amount of the assessment must nevertheless pay the tax but may appeal to the central tax collection agency. If the matter is not resolved by the central tax collection agency, the taxpayer may appeal to the Minister of Finance and any decision rendered at this level is final.

Chapter VI: Penalties

The tax authorities are empowered to impose penalties for violation of the import/export legislation. A taxpayer who disagrees with a decision of the tax authorities may file an appeal to the central tax collection board but he must still pay the penalty. A decision of the central tax collection board is final.

Art. 13 sets forth the penalties which will be imposed in cases of late filing, fraudulent acts or other acts in contravention of the import/export legislation. Late filers will be subject to a daily fine amounting to 5 one thousandths of the amount of the unpaid tax. Taxpayers who commit fraudulent acts may receive either a warning or a fine amounting to 2 to 5 times the amount of the tax fraud involved. Taxpayers committing any other acts in contravention of the law (with respect to tax computation, collection or payment) may be subject to disciplinary measures, administrative sanctions or punishment as provided by the criminal code.[15]

Chapter VII: Final clauses

The import/export legislation takes effect as of 1 February 1988 and the Council of Ministers will provide regulations for implementation of the law.

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independent trade corporations. There are both national and regional import/export corporations. All commercial or non-commercial payments to foreign countries are effected through the Bank of Foreign Trade of Viet-Nam (Vietcombank), cf. *The Far East and Australasia, 1988,* 19th edition, London (1987) at 1012.

12. Viet-Namese currency: 100 xu = 1 new dong. The new dong, equivalent to 10 former dong, was introduced in September 1985; see *The Far East and Australasia,* loc. cit. at 1006.

13. In cases where goods eligible for tax reduction or exemption later become taxable due to a change in terms or circumstances, the import/export tax will be levied.

14. The tax collection agency must provide this information within 8 hours of receiving the declaration.

15. Art. 169 of the Criminal Code provides for re-education without detention for a period of up to one year or imprisonment for a term between 3 months and 3 years.

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MALAYSIA:

An Outline of the 1989 Budget Proposals

Susan M.C. Lyons

I. INTRODUCTION

In his Budget Speech[1] delivered to the House of Representatives on 21 October 1988, the Finance Minister, the Honorable Y.B. Datuk Paduka Daim Zainuddin, presented a fairly positive evaluation of the general economic situation. Emphasizing recovery from the economic recession which has plagued Malaysia, he expressed his gratitude to all sectors of the economy which contributed to the improved economic climate.

Opening his speech with a review of the Malaysian economy, the Minister declared 1988 as a significant year during which many of the challenges spawned by the economic recession were met and overcome. A 7.4% increase in the real GDP is expected for 1988, export prices for raw materials (rubber, palm oil) were high, and the demand for Malaysian manufactured products has risen. Crude oil prices, however, have been erratic due to an oversupply and uncertainties in the oil market and a reduction of US$ 2 per barrel is forecast for this year, i.e. US$ 16 per barrel as opposed to US$ 18 in 1987.[2]

The 1989 Budget strategy is designed to sustain and strengthen economic recovery. The Budget offers, inter alia, reduced corporate tax rates, disallowance of certain deductible expenses, extension of the sales tax and a reduction in tariff protection for certain industries.

II. CHANGES IN TAXATION

A. Tax reform

The Minister of Finance pointed out deficiencies which have been observed in the Malaysian tax system. For example, revenue production has been eroded by the generous exemptions and reliefs and the tax base is too narrow because about one-third of the tax revenue derives from petroleum-related taxes. To eliminate these deficiencies, attract investment and foster economic growth, the Minister proposed a tax reform package to be implemented in stages. The following measures have been proposed:

- reduction in direct taxes;
- review of existing reliefs and deductions allowed to companies under the Income Tax Act;
- special tax relief for new and high risk undertakings;
- review of tax incentives granted under the Promotion of Investments Act (PIA) while maintaining major tax incentives to promote investment; and
- extension of the sales tax to include more non-essential items.[3]

1. Reduction in the rate of company tax and abolition of the development tax[4]

With a view to attracting investment and stimulating economic growth, the Finance Minister has proposed a reduction in the rate of company tax from its present 40% to 35% (with effect from year of assessment 1989)[5] and gradual abolition of the 5% development tax which is imposed on companies. The development tax will be reduced by 1% starting in the 1990 year of assessment.[6]

2. Entertainment expenditure

Entertainment expenditures and entertainment allowances are fully deductible (by individuals and companies) in computation of taxable income so long as the expenses are incurred wholly and exclusively in the production of gross income. The Minister has proposed that the deduction no longer be allowed with respect to entertainment expenditures and allowances paid to employees.[7] This proposal is to take effect from the year of assessment 1989.

3. Free passage allowance

Companies may deduct the cost of employee free passage allowances (one passage outside Malaysia and 3 passages within Malaysia annually). The Minister has proposed that this deduction be eliminated. This proposal is also to be effective from the 1989 year of assessment.

4. Amendments to the Petroleum Income Tax Act 1967 (PITA)

Several measures are to be introduced (with effect from the 1989 year of assessment) to streamline and improve administration of the PITA. First, income derived from more than one petroleum agreement will be taxed separately. To enable petroleum companies to write off qualifying expenditures on exploration and secondary recovery at a faster rate, the 5% annual allowance for qualifying exploration expenditures will

1. The Budget Speech was accompanied by a series of Appendixes. References are made in the footnotes to these Appendixes.
2. Para. 6 of Budget Speech.
3. Para. 18 of Budget Speech.
4. Under the Supplementary Tax Act 1967, a development tax is imposed in addition to income tax.
5. The reduction in the rate of company tax will not apply to petroleum companies under the Petroleum Income Tax Act 1967 (see text below).
6. Para. 21 of Budget Speech.
7. Certain categories of entertainment expenses, however, will remain deductible, inter alia, entertainment provided for employees, expenditures for promotional gifts or samples and entertainment in the form of cultural or sporting events which are open to members of the general public and which are offered solely to promote the business of the taxpayer.

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be increased to 15% and the 6% annual allowance for qualifying plant expenditures for secondary recovery will be increased to 10%.[8]

In addition, certain deductions will also be granted to petroleum companies. A double deduction will be allowed for expenses incurred in respect of the remuneration paid to handicapped persons and for insurance premiums on cargo imported into Malaysia (provided the insurance contract is executed with a company incorporated in Malaysia).[9] Payments made towards the Petroleum Research Fund will also be deductible.[10]

5. Deduction for bonus payments

The current deduction for bonus payments made to or on behalf of an employee is set at a maximum of $ 1,000 or 2 months salary, whichever is higher. With a view to encouraging employees to increase productivity, the Minister has proposed that the deduction be increased to $ 2,000 or 2 months salary plus any additional sum which shall not be more than twice the percentage increase in the company's net profits, whichever is higher.[11] This proposal is also to take effect as of the 1989 year of assessment.

6. Exemption of charitable institutions

All income (with the exception of dividend income) derived by charitable institutions engaging in charitable activities are exempt from income tax by virtue of Para. 13, Schedule 6 to the Income Tax Act 1967. Many institutions have diversified considerably making it difficult to ascertain whether the activities are in fact "charitable". Consequently, the Minister made the following remedial proposals:

(a) charitable institutions must apply to the Department of Inland Revenue for exempt status;
(b) at least 70% of the income of charitable institutions must be spent for charitable purposes; and
(c) only charitable institutions established in Malaysia and activities carried out in Malaysia will be eligible for the exemption.[12]

7. Withholding tax on interest payments

The present withholding tax exemption for interest paid by financial institutions on fixed deposits with maturity periods of more than 12 months has resulted in differential tax treatment of interest income with varying maturity dates.[13] The Minister has proposed a withdrawal of this exemption and the imposition of a 5% withholding tax on such interest derived by residents.[14] The withholding tax exemption granted to non-residents will be maintained to encourage the flow of capital into Malaysia. The proposal is effective as of 1 January 1989.[15]

8. Review of tax incentives

The Promotion of Investment Act (PIA) 1986 provides a comprehensive range of incentives designed to compensate for the high rate of company tax (40%), development tax (5%) and excess profits tax (3%). In order to ensure that the tax incentives comport with the Government's policy, i.e. to streamline incentives, protect revenue and encourage investment, several proposals have been made:[16]

- companies which apply for pioneer status after Budget Day will be required to utilize their capital allowances during the pioneer period. No carry-forward will be allowed for unused capital allowances;
- losses incurred during the tax holiday which cannot be utilized may not be carried forward;
- the accelerated depreciation allowance which expires at the end of 1988 will not be extended.

These proposals will take effect as of the 1990 year of assessment.[17]

B. Sales tax

The 1988 Budget introduced 2 amendments to the sales tax system, i.e. the tax base was broadened by the reimposition of sales tax on certain items (e.g. certain foodstuffs, building materials, semi-processed and non-essential goods) and the availability of tax-free raw materials and components was restricted to manufacturers who produce goods subject to sales tax.[18] However, the tax base needs to be broadened even further so a 5% sales tax is proposed on other foodstuffs and building materials.

C. Value added tax

The Minister conceded that the proposed reduction in direct taxes will result in substantial revenue losses. To compensate for these losses and alleviate the weaknesses of the sales tax, the Minister recommended that VAT be adopted to replace the sales tax. He cautioned, however, that the ramifications of such a move need to be studied.[19]

D. Reduction in tariff protection for certain industries

Various industries have been granted extensive tariff protection to assist them during their infant years. The Minister has proposed that a review be conducted of industries which have enjoyed at least 50% protection for more than 10 years and that import duties on cer-

8. Para. 26 of Budget Speech.
9. These deductions are already allowable to companies under the Income Tax Act 1967.
10. Para. 27 of Budget Speech.
11. Para. 28 of Budget Speech.
12. Para. 30 of Budget Speech.
13. As a general rule, a 5% withholding tax is imposed on interest income.
14. However, the interest earned from deposits with the National Savings Bank and Pilgrimage Management Fund Board will not be affected.
15. Para. 31 of Budget Speech.
16. The major incentives such as the Pioneer Status Incentives, the Investment Tax Allowance and various double deductions will remain unchanged.
17. Para. 32 of Budget Speech and Appendix VIII.
18. Para. 33 of Budget Speech. Exports and small manufacturers will continue to be exempt from this tax.
19. Para. 34 of Budget Speech.

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tain goods (e.g. bicycles, chocolate, biscuits and beverages) be reduced between 20% to 87%.[20]

III. ENHANCING THE ROLE OF THE PRIVATE SECTOR

A. Capital expenditure on agricultural products

The National Agriculture Policy encourages entrepreneurs to undertake large-scale commercial agricultural ventures for purposes of export. Because such ventures generally entail high risks it is proposed that capital expenditures incurred on approved agricultural projects be allowed as a deduction from aggregate income (including income from other sources). A time frame and mininium hectarage of production will be imposed for various undertakings and the proposal will be effective from the year of assessment 1989.[21]

B. Incentives for construction companies

Under present legislation income earned abroad and remitted into Malaysia is subject to tax at the normal tax rate. To encourage construction companies to undertake foreign construction projects and remit the earned income to Malaysia, the Minister has proposed that the income be granted an abatement of 50% which will be exempt from income tax and development tax. Dividends paid out of the exempt income will also be exempt from income tax in the hands of the shareholders. This special tax treatment will only be available to projects implemented between Budget Day and 1993 whose income is remitted to Malaysia within 5 years of commencement of the project. This proposal is effective from Budget Day.[22]

C. Repeal of the Share (Land Based Company) Transfer Tax Act 1984 and amendments to the Real Property Gains Tax Act 1976

The Share Transfer Tax Act (STTA) was enacted, inter alia, to close a loophole in the Real Property Gains Tax Act (RPGTA) which allowed land-based companies to sell shares rather than land so as to avoid paying real property gains tax.[23] However, a "land-based company" is broadly defined in the STTA and this has hindered bona fide restructuring and amalgamation of companies. The Minister has proposed that the STTA be abolished and the RPGTA be amended to provide that a controlled company which owns real property and/or shares, the defined value of which is not less than 75% of its total tangible assets, will be considered a real property company and that gains from the sale of shares in a real property company be subject to real property gains tax.[24]

D. Tax incentives for small scale industries

Consistent with the Government policy of enhancing industrial development and creating employment opportunities, small scale industries are granted incentives under the PIA 1986. With a view to further encouraging investment in small scale manufacturing industries, 5 proposals have been made:

(1) that small scale industries which meet specified criteria be granted pioneer status;
(2) that the 40% reinvestment allowance for these industries be increased to 50%;
(3) that a full exemption from import duties on raw materials, components, machinery and equipment be granted;
(4) an abatement based on 5% of the adjusted income or the total value of components purchased (whichever is lower) be allowed to large industries which purchase components from small scale industries; and
(5) a double deduction be allowed on the cost of training with the National Productivity Centre, Standards and Industrial Research Institute Malaysia, MARA Institute of Technology and Malaysian Agricultural Research and Development Institute.

In order to qualify for the incentives, a small scale company must be resident and incorporated in Malaysia. This proposal is effective as of year of assessment 1990.[25]

E. Financing for small and medium scale industries

To assist small and medium scale industries in obtaining reasonable financing the Government is developing a scheme with funds from the ASEAN-Japan Development Fund (AJDF). Credit will be obtained through certain Malaysian banks.[26]

F. Tax incentives for operational headquarters

With a view to attracting multinationals to Malaysia, the Government is preparing a tax incentive scheme for the establishment of operational headquarters.[27]

IV. DEVELOPMENT OF THE CAPITAL MARKET

Investment in corporate securities accounts for most capital market investment in Malaysia. The Government considers that diversification of the capital market will foster financial stability as well as offer investment alternatives. Consequently, several measures have been proposed concerning corporate bonds,

20. Para. 35 of Budget Speech.
21. Para. 37 of Budget Speech.
22. Para. 39 of Budget Speech.
23. Under the STTA, every disposal of shares (on or after 19 October 1984) where the disposal value exceeds M$ 1 million is taxed at a flat rate of 2% on the gross value of the asset. With respect to disposals within a period of 12 months, the tax applies if the aggregate disposal value exceeds M$ 1 million.
24. Para. 40 of Budget Speech and Appendix XI.
25. Para. 41 of Budget Speech and Appendix XII.
26. Para. 42 of Budget Speech.
27. Para. 44 of Budget Speech.

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share unit trusts, property unit trusts and venture capital companies.

A. Corporate bonds

Corporate bonds are now subject to a 0.5% stamp duty at the time of issue, a 0.1% duty at the time of transaction in the bonds and 0.3% at the time of transfer of the bonds.[28] The Minister has proposed that stamp duties on instruments relating to corporate bonds be exempted from the stamp tax in order to invigorate development of the capital market and transactions in corporate bonds. This proposal is to be effective from 1 January 1989.[29]

B. Share unit trusts and property trusts

The Government desires to encourage the growth of unit trusts and property trusts as a means for the mobilization and investment of funds. Under current legislation, gains derived by such trusts from the sale and purchase of shares are considered business income and therefore subject to the normal rate of company tax, i.e. 40%. The high rate of tax hinders development of unit trusts and property trusts so the Minister has proposed that the legislation be amended to the effect that gains from the sale of such shares not be regarded as business income and consequently not subject to income tax.[30]

C. Venture capital companies

The Finance Minister has proposed that legislation be amended to promote growth of venture capital companies.[31]

V. EXPORT CREDIT REFINANCING (ECR) SCHEME

The Minister announced the Government's intention to continue with the measures designed to promote exports and strengthen the export base. For example, efforts will be made to improve access to bank financing by small enterprises and new exporters, priority will be given to expand access to the Pre-Shipment ECR Scheme to include more exporters, in particular new and indirect exporters having inadequate bank collateral, and steps taken to revamp and improve the export credit insurance scheme to complement the ECR Scheme.[32]

28. The bond certificate is also subject to a $ 2 stamp duty per certificate.
29. Para. 47 of Budget Speech and Appendix XIII.
30. Paras. 48-51 of Budget Speech.
31. Para. 53 of Budget Speech.
32. Para. 55 of Budget Speech.

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AUSTRALIA:

Press Release

17 NOVEMBER 1988 STATEMENT BY THE TREASURER, THE HON. P.J. KEATING, M.P.: COMPREHENSIVE TAXATION AGREEMENT BETWEEN AUSTRALIA AND CHINA

On the occasion of Premier Li Peng's visit to Australia, the Chinese Foreign Minister, Mr. Qian Qichen, and I today signed a comprehensive agreement between Australia and the People's Republic of China for the avoidance of double taxation.

The agreement prevents double taxation by allocating taxing rights to Australia or China on all forms of income flowing between the 2 countries. The basis of allocating these rights is substantially similar to that adopted in Australia's other modern double taxation agreements.

The agreement provides for certain types of income to be taxed in full by the country in which the income has its source. Income dealt with in this manner includes income from real property (including income from the exploitation of natural resources), business profits attributable to a "permanent establishment", that is, a substantial business presence which is situated in the country of source, income from employment except in relation to some visits of short duration, and income derived by entertainers and athletes.

Other types of income may be taxed only by the country of residence of the recipient. Items falling within this category include shipping profits derived from international operations, income from professional services or other independent activities of a similar character (unless a fixed base is available in the other country for the purpose of performing those services or activities), and most pensions and annuities other than certain government service pensions. The existing taxation agreement with China on international air transport operations will continue to apply to profits from such operations.

Income comprising dividends, interest and royalties may be taxed by both countries. The country of source, however, is to limit its tax to not more than 15% of the gross income in the case of dividends; and 10% in the case of interest and royalties. Double taxation is avoided in respect of this category of income by the country of residence allowing credit against its tax on the income for the limited tax paid in the source country.

If a resident of one country has a permanent establishment or fixed base in the other country and receives dividends, interest or royalties in connection with that permanent establishment or fixed base, the abovementioned limited source country tax will not apply. In such a case, the source country has the right to tax the dividend, interest or royalty income in full.

The limit of 10% on the tax of the country of source in respect of interest and royalties derived by a resident of one country from a source in the other will not affect Australia's interest withholding tax, which is payable at the rate of 10% under our domestic law. However, the limit will result in a reduction in Australian tax on royalties flowing to China in cases where the tax payable by assessment on the net royalty would have been greater.

The agreement also provides for such things as the exchange of information and for consultation between the taxation authorities of the 2 countries.

Tax sparing provisions require Australia to allow a tax credit to Australian residents for tax forgone by China under certain of its development incentive legislation that is specified in the agreement.

To avoid unnecessary delays in giving it effect, this agreement was finalised on the basis of the existing income tax laws of Australia and China and without regard to changes in those laws foreshadowed in both countries.

The agreement will enter into force when the Australian and Chinese Governments have exchanged notes advising each other that the last of the necessary constitutional processes to give the agreement the force of law in their respective countries has been completed. In Australia, legislation will be necessary to give the agreement the force of law and a Bill for that purpose will be introduced into Parliament as soon as practicable.

Upon entry into force, the agreement will have effect in Australia for all Australian taxes covered by the agreement (including taxes withheld at source) in respect of income derived on or after 1 July in the calendar year following that in which it enters into force.

The agreement will have effect in China in respect of all Chinese taxes covered by the agreement in respect of income derived on or after 1 January in the calendar year following that in which it enters into force.

Copies of the agreement will be available to interested persons at Taxation Offices in the capital cities.

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PUERTO RICO:

Individual Income Taxes

Arthur Young International

The tax laws of Puerto Rico (as amended by the 1987 Puerto Rico Tax Reform Act) are modeled after the U.S. tax laws and, in fact, have adopted most of the features which are incorporated into the federal system including those brought in by the U.S. 1986 Tax Reform Act. Differences between the 2 systems do exist, however, particularly in the amounts allowed for personal and dependency exemptions, the deductible portion of various expenses, the tax treatment of certain income items such as interest and dividends and the taxation of married persons.

Under Puerto Rico law, the concept of taxable income (defined as gross income less all allowable deductions, personal exemptions and credit for dependents) is computed in a manner generally similar to the way it would be computed under U.S. law. A major difference between Puerto Rico's income tax laws and those of the United States is that under U.S. law, there are separate tax rate tables for each type of taxpayer. Puerto Rico law, however, provides for only one tax table which is used for all taxpayers regardless of their marital status with the exception that Puerto Rico now permits married persons to file separate returns. In order to reduce the tax burden on income-earning spouses filing joint returns in Puerto Rico, a special deduction is granted (the Marital Deduction).

The Puerto Rico tax year corresponds to the calendar year. Tax returns are due on or before 15 April following year-end. The Puerto Rico tax system, like the U.S. system, is a self-assessing one in which the taxpayer computes the tax liability and generally pays any balance due with the return. Puerto Rico also has a withholding system on compensation. Residents of Puerto Rico are required to make estimated payments in the following circumstances:

- An individual who is single or married but not living with his spouse and whose gross income, not subject to withholding, exceeds 50% of his total estimated gross income from all sources or exceeds $ 5,000.
- If the taxpayer is married and living with his spouse, he will be required to file an estimated tax return if the gross income received by both spouses, not subject to withholding, exceeds 50% of their total estimated gross income from all sources or exceeds $ 10,000.

In determining the extent to which an individual will be taxable in Puerto Rico, it is important to first consider the residence status of the taxpayer. An individual who has not been resident in Puerto Rico at any time during the entire taxable year is subject to Puerto Rico taxation only on income derived from sources within Puerto Rico. Certain special deductions (see below) must be prorated if the taxpayer is a part-year resident during the taxable year. Once an individual becomes resident in Puerto Rico he/she becomes subject to taxation on *all* income, no matter where earned, since Puerto Rico has a worldwide concept of taxation similar to that of the United States.

The overall tax picture for U.S. citizens or residents who become bona fide residents of Puerto Rico is somewhat unique. In the year in which an individual establishes residency in Puerto Rico he/she will be subject to tax on worldwide income under both U.S. and Puerto Rico laws. In order to avoid the obvious difficulties of double taxation on the same income, both the United States and Puerto Rico have incorporated provisions into their laws which permit taxes paid to one to be claimed as a credit in computing the tax liability to the other. This foreign tax credit mechanism effectively limits the tax on the individual to the greater of the U.S. or the Puerto Rico tax. While generally speaking, the Puerto Rico tax rates are higher than the U.S. tax rates at equivalent income brackets, the determination as to which tax liability is greater in this transitional year depends on such factors as the date residency begins, as well as the nature of the income.

U.S. citizens and residents who are bona fide residents of Puerto Rico for the entire tax year fall under a special provision of the U.S. law. Sec. 933 of the U.S. Internal Revenue Code provides that these individuals do not report on their U.S. tax return any income earned from sources within Puerto Rico. Income earned outside Puerto Rico remains fully taxable in the United States. This would include such income as dividends and interest in the United States, compensation earned while traveling outside of Puerto Rico (either in the United States or elsewhere in the world), regardless of where paid, rental income from property outside of Puerto Rico, etc. It should be noted, however, that any expenses which relate to income which have been excluded from the U.S. return are not deductible. This section of U.S. law also contains benefits for U.S. citizens leaving Puerto Rico. If a U.S. citizen has been a bona fide resident of Puerto Rico for at least 2 years, then in the year of the move from Puerto Rico he/she may exclude from the U.S. return any amounts earned from Puerto Rico sources which relate to the period of residency (referred to as "split year" return).

GROSS INCOME

Generally speaking, Puerto Rico taxes the same income items as are taxed under U.S. law. Gross income, therefore, includes such items as income earned from the following:

1. Personal services
2. The conduct of a trade or business

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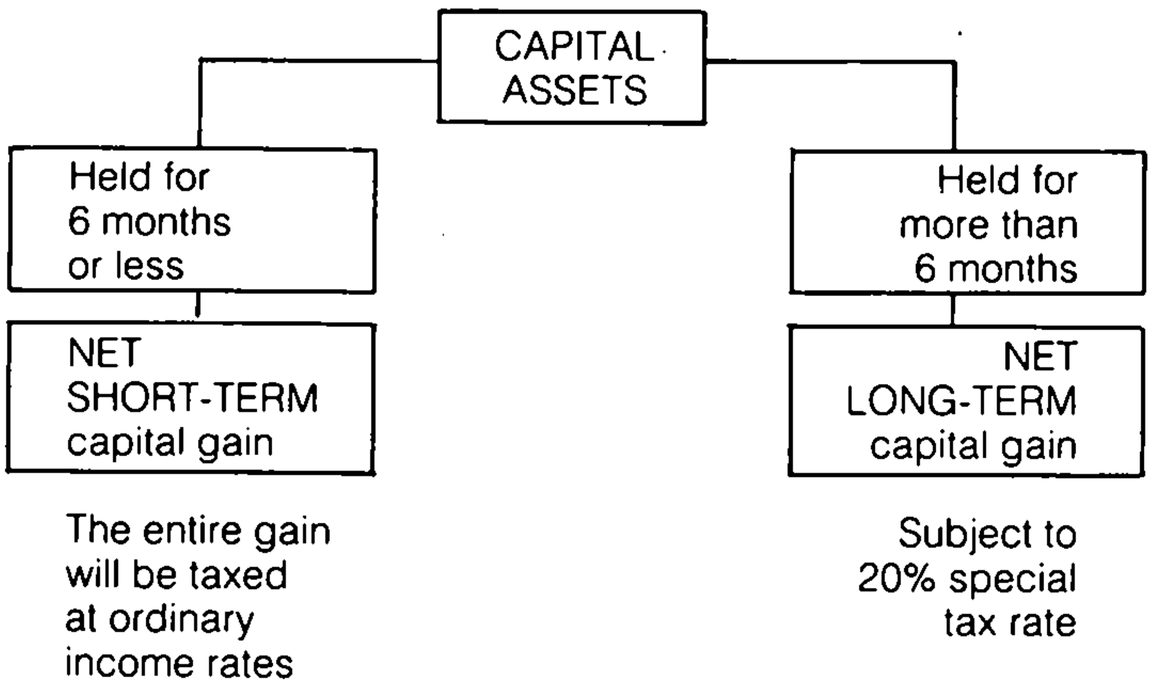
3. Interest
4. Rent
5. Dividends
6. Partnership profits
7. Security transaction
8. Sales or exchanges of personal and/or real property

INTEREST

Among the items which are entirely exempt from tax in Puerto Rico is interest on U.S., any state of the U.S. and Puerto Rico government obligations. Certain other types of income are excludable up to a specific annual limit. An example would be the exemption permitted for the first $ 2,000 of interest received from local banks or from local branches of foreign banks (modified in the case of married couples filing separately). Also, interest earned on savings accounts or certificates with local banks or local branches of foreign banks (qualified deposits) will be subject to a flat 17% maximum tax, provided the taxpayer elects to have the taxes withheld at source by the banking institution. Similarly, dividends received from domestic corporations or foreign corporations with 80% or more of their gross income from Puerto Rico sources, are subject to a flat 20% maximum tax, provided the taxpayer elects to have the taxes withheld at source by the distributing corporation.

CAPITAL GAINS

Generally, gains resulting from the sale or exchange of property owned by the taxpayer are afforded special tax treatment under the capital gains rules. Capital gains must be fully reported on the tax return. Following is a table which summarizes the capital gain rules:



If there is an excess of net capital losses over net capital gains, it is deductible against ordinary income up to an annual limit of $ 1,000. There are provisions which allow a 5-year carry-forward period for capital losses in excess of this annual limit.

In a manner similar to U.S. law, if an individual sells his principal residence and, within 12 months, reinvests the entire price in a new principal residence in Puerto Rico, the gain is taxed only to the extent that the selling price of the old residence exceeds the cost of purchasing the new residence. In the case of taxpayers, 60 or over, the first $ 50,000 of gain on the sale of residence is excluded ($ 25,000 per spouse if filing separate returns).

ADJUSTED GROSS INCOME (AGI)

Adjusted gross income can generally be defined as gross income less certain business-related deductions. Its importance lies in the fact that it is the base upon which certain other deductions are computed. Examples of the types of deductions allowed in arriving at adjusted gross income include:

1. Deductions on account of a trade or business carried on by the taxpayer.
2. Travel, meals and lodging expenses incurred while away from home on account of the performance of services as an employee.
3. Other expenses incurred in connection with performance of services as an employee under a reimbursement or other expense allowance arrangement with the employer.
4. Deductions attributable to property held for the production of rents or royalties.
5. Losses on the sale or exchange of property.
6. "Special partnership" losses, as defined in the law, subject to a limitation of up to 50% of taxpayer's taxable income.

DEDUCTIONS

Puerto Rico tax law allows a standard deduction (in lieu of special deductions) which varies according to the individual's status. The amount of the deduction is as follows:

Taxpayer's status	*Standard deduction*
Single	$ 2,000
Married – living together	$ 3,000
separated	$ 2,000
Married – filing separate	$ 1,500
Head of household	$ 2,600

SPECIAL DEDUCTIONS

Taxpayers are entitled to claim certain special deductions in lieu of the standard deduction if these result in a higher amount. Some of these special deductions are:

1. Medical expenditures

The allowable deduction is the excess of one-half of the eligible medical and dental expenses over 3% of the adjusted gross income.

2. Contributions

Contributions are deductible to the extent that they exceed 3% of adjusted gross income. This deduction is generally limited to 15% of adjusted gross income.

3. Taxes

Taxes paid on property which is the taxpayer's princi-

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pal residence as well as license fees connected with an automobile used for the taxpayer's personal use are deductible. Compulsory insurance premium (ACAA) is not deductible.

4. Interest

Interest paid on the taxpayer's personal indebtedness is deductible as follows:

Interest deduction	*Mortgage* (purchasing or refinancing)	*Auto*	*Consumer loans*
– Principal residence and second home (up to market value)	100%		
– Personal auto		1988 – 67% 1989 – 33% $ 1,200 max.	
– Credit cards, personal loans, etc.			1988 – 67% 1989 – 33% 1990 – 0%

5. Casualty losses

A deduction is allowed for loss or damage to the taxpayer's residence caused by fire, severe storm, etc. Casualty losses to personal property as a result of natural disasters are also deductible up to a limit of $ 5,000.

6. Rent

10% of the total annual rent paid on the taxpayer's residence is deductible (up to a maximum of $ 5,000 per year).

7. Child care

Expenses up to $ 400 for one child or $ 800 for 2 or more children may be deducted. The following requirements must be met:

(a) The dependent must be a child of the taxpayer and not over 14 years old;
(b) The expense must be incurred so as to enable the taxpayer to be gainfully employed. In the case of married individuals, both spouses must be gainfully employed.

SPECIAL ADDITIONAL DEDUCTIONS

The following deductions are allowed in addition to the standard or special deductions, regardless of which option the taxpayer exercises in claiming:

1. Veteran's deduction

A resident of Puerto Rico who has served on active duty in the U.S. armed forces and who has received an honorary discharge is entitled to a special deduction of $ 500. This deduction is valid during the lifetime of the taxpayer from the date of discharge. In order to claim the deduction, the taxpayer will be required to submit a copy of Form DD-214 (Honorable Discharge Document issued by the U.S. Department of Defense).

2. Ordinary and necessary expenses incurred in connection with the exercise of a profession or as an employee

1988: $ 5,000 or 10% of AGI, whichever is lower.
1989: $ 3,000 or 6% of AGI, whichever is lower.
1990: $ 1,500 or 3% of AGI, whichever is lower.

3. Contributions to individual retirement accounts

Individual taxpayers can deduct from their gross income the contributions made to individual retirement accounts qualifying as such under the law. The maximum deduction allowed an individual for any taxable year shall not exceed the lesser of $ 2,000 or the taxpayer's earned income derived from salaries or attributable to professions or occupations. In the case of married couples, both spouses may contribute to their own retirement account with regard to income individually earned or the working spouse may establish an account for the non-working spouse with a $ 4,000 deduction limitation.

4. Deduction for 2-earner married couple (Marital deduction)

Two-earner married couples living together are entitled to a special deduction in an amount equal to 10% of the income earned by the spouse with the lower earned income. The deduction cannot exceed $ 200 per year and they must file a joint return.

5. Interest paid on auto loans

Starting in 1989, a fixed deduction of up to $ 1,200 of interest paid on the taxpayer's automobile.

Taxpayers are required to attach written evidence to their returns which supports payments made for special deductions.

PERSONAL AND DEPENDENCY EXEMPTIONS

Personal exemptions are as follows:

1. Single or married person not living with the spouse at the end of the taxable year – $ 1,300.
2. Married person living with his/her spouse at the end of the taxable year as well as heads of families – $ 3,000.
3. Married person filing separate returns – $ 1,500.
4. Dependents other than university students – $ 1,300.
5. Dependents that are regular university students – $ 1,600 each. A certificate from the university accrediting full-time status during at least one semester will be required. Such students may earn up to $ 3,300 and the parent will not lose the dependent exemption.
6. Dependents who are mentally or physically handicapped, blind or age 65 or over – $ 1,300 each.

INDIVIDUAL INCOME TAX RATES UNDER THE 1987 PUERTO RICO TAX REFORM ACT

Marginal effective tax rates	*Net taxable income*		
	1988	*1989*	*1990*
9%	$ 0 – 2,000	$ 0 – 2,000	$ 0 – 2,000
15%	2,001 – 13,000	2,001 – 13,000	2,001 – 17,000
25%	13,001 – 30,000	13,001 – 30,000	17,001 – 30,000
	30,001 or over at *41%*	30,001 or over at *38%*	30,001 or over at *33%*

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For the first time, a married person living with spouse may file a separate return. In such case, the following tax rates apply:

	Marginal effective tax rates		
Taxable income	*1988*	*1989*	*Post 1989*
$ 0 – $ 1,000	9%	9%	9%
$ 1,001 – $ 6,500	15%	15%	15%
$ 6,501 – $ 8,500	25%	25%	15%
$ 8,501 – $ 15,000	25%	25%	25%
$ 15,500 – $ 37,500	41%	38%	33%

The Law provides for a recapture of the benefit of the lower tax rates (9%-25%) which, in effect, subjects the taxpayers' income to the maximum rate of 41% (in 1988), when taxable income exceeds $ 7,500, by imposing a 5% surtax on the excess over $ 75,000.

An alternate basic tax (to be paid if higher than above) will apply to individuals with adjusted gross income (modified) as follows:

Modified adjusted gross income	*Alternate basic tax (min)*
$ 75,001 – 125,000	10%
$ 125,001 – 175,000	15%
$ 175,001 or over	20%

EFFECTIVE DATE OF LAW

The provisions of the 1987 Puerto Rico Tax Reform Law are applicable to individuals effective 1 January 1988 (taxable year 1988). The law provides an option to taxpayers allowing them to elect to prepare their tax returns during the 5-year period of 1988 through 1992 under present law or the old law, whichever results in the lower amount of taxes to the taxpayer.

EXAMPLE OF PUERTO RICO TAX COMPUTATION

Facts

Mr. Expatriate is a bona fide resident of Puerto Rico for the entire calendar year 1988. He is married with 2 children (one of whom is a university student). His compensation, including allowances, is $ 50,000, all of which is earned in Puerto Rico. In addition, his wife earns $ 10,000. During the year, both spouses made the maximum individual contribution to their Individual Retirement Account (IRA). He has interest from a separate *local branch* of a New York bank of $ 2,700 and dividends of $ 300. During 1988, he sells 100 shares of AB Co. stock for $ 4,000 which cost $ 1,500 8 months earlier. He pays rent of $ 800 per month for his apartment and has interest expense of $ 1,400 on a personal loan. Unreimbursed medical expenses amount to $ 4,000 for the year.

Computation

Husband's compensation		$ 50,000
Wife's compensation		10,000
Interest:		
Received	$ 2,700	
Excludable	(2,000)	
Net		700
Dividends		300
Gain on sale of stock ($ 4,000 – $ 1,500 = $ 2,500)		2,500
Adjusted gross income		63,500
Deductions:		
Standard deduction	$ 3,000	(3,000)
Special deductions (if greater than standard deduction):		
Rent (10% × $ 9,600 limited to $ 500)	$ 500	
Interest ($ 1,400 × 0.67)	938	
Medical ($\frac{\$ 4,000}{2}$ – ($ 63,500 × 3%))	95	
	$ 1,533	
Special additional deductions:		
Contribution to IRA:		
Husband $ 2,000		
Wife 2,000	4,000	
Joint Income Earners Deduction:		
Wife ($ 10,000 × 10%, limited to $ 200)	200	
	4,200	(4,200)
Personal exemption – married and living with spouse		(3,000)
Dependents:		
University student (1 × $ 1,600)		(1,600)
Non-university student (1 × $ 1,300)		(1,300)
Taxable net income		$ 50,400
Income tax computation:		
First $ 2,000 (9%)	$ 180	
Next $ 11,000 (15%)	1,650	
Next $ 17,000 (25)	4,250	
Excess over $ 30,000 ($ 20,400 × 0.41)	8,364	
Regular tax liability		$ 14,444 (A)
Tax on income excluding capital gains ($ 47,900)	$ 13,419	
Add: tax on capital gains ($ 2,500 × 0.20)	500	
Alternative tax liability		$ 13,919 (B)
Tax liability (the lower of (A) or (B))		$ 13,919

If Mr. Expatriate were to make arrangements with the local branch of the New York bank to have the applicable tax withheld on the interest, the total Puerto Rico tax liability would be:

Tax on income excluding capital gains and interest ($ 47,200)	$ 13,132
Add: tax on capital gain ($ 2,500 × 0.20)	500
Add: tax on interest ($ 700 × 0.17) (This tax will be withheld at source by the bank)	119
Total	$ 13,751

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Comparative table of the individual income taxation in Puerto Rico

Items	*U.S. citizens*		*Foreign individuals*			
	Residents	*Non-residents*[1]	*Residents*	*Non-residents*		
				Engaged in trade or business in Puerto Rico	*Not engaged in trade or business in Puerto Rico*	
					Gross income not over $ 22,200	*Gross income over $ 22,200*
1. Includable gross income:						
(a) From all sources (within and without P.R.)	Yes	No	Yes	No	No	No
(b) All classes of income from P.R. sources only	—	Yes	—	Yes	No	No
(c) Fixed or determinable income from P.R. sources only	—	—	—	—	Yes	No
2. Deductions:						
(a) Business expenses allocable to income from all sources	Yes	No	Yes	No	No	No
(b) Business expenses allocable to income from P.R. sources only	—	Yes	—	Yes	No	Yes
(c) Losses incurred in any transaction entered into for profit in P.R.	Yes	Yes	Yes	Yes	No	No
(d) Standard deduction	Yes	Yes	Yes	No	No	No
(e) Itemized deductions:						
Interest on personal loans, medical expenses, etc.	Yes	Yes	Yes	No	No	No
Charitable contributions	Yes	Yes	Yes	Yes	No	Yes
3. Personal exemption	Yes	Yes	Yes	No	No	No
4. Credit for dependents	Yes	Yes	Yes	No	No	No
5. Foreign tax credit	Yes	No	Yes	No	No	No
6. Tax rates	Ordinary rates	Ordinary rates	Ordinary rates	Ordinary rates	29%	Ordinary rates (but not less than 29%)
7. Capital gains and losses from P.R. sources:						
(a) Capital loss deduction up to the capital gains	Yes	Yes	Yes	Yes	Yes	Yes
(b) Net capital loss deduction up to $ 1,000 of net ordinary income	Yes	Yes	Yes	Yes	No	Yes
(c) Net capital loss carryover	Yes	Yes	Yes	Yes	No	No
(d) Special 20% tax on LTCG	Yes	Yes	Yes	Yes	No	No

1. U.S. citizens who are non-residents of Puerto Rico are generally taxed in the same way as the residents of Puerto Rico, but only in regard to income and deductions allocable to Puerto Rico. *Postley v. Sec.*, 75 P.R.R., 874 (1954) and Sec. 116.

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UNITED STATES:

THE TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 (TAMRA): TAXPAYER BILL OF RIGHTS

On 21 October 1988 the TAMRA was passed by the U.S. Congress. The Act contains a plethora of technical amendments to, inter alia, the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1986 and the Revenue Act of 1987. However, the TAMRA also includes various substantive provisions, the most significant of which is the new taxpayer Bill of Rights. These provisions are designed to strengthen and safeguard the rights of taxpayers with respect to taxpayer interviews, audits and the tax collection process. The Bill of Rights extends the notification period before the IRS levies property and exempts more property from levy. The jurisdiction of the Tax Court is also expanded. The text of Secs. 6226-6247 is reprinted in this issue.

Subtitle J-Taxpayer Rights and Procedures

SEC. 6226. SHORT TITLE.

This subtitle may be cited as the "Omnibus Taxpayer Bill of Rights".

PART I – TAXPAYER RIGHTS

SEC. 6227. DISCLOSURE OF RIGHTS OF TAXPAYERS.

(a) IN GENERAL. – The Secretary of the Treasury shall, as soon as practicable, but not later than 180 days after the date of the enactment of this Act, prepare a statement which sets forth in simple and nontechnical terms–

(1) the rights of a taxpayer and the obligations of the Internal Revenue Service (hereinafter in this section referred to as the "Service") during an audit;

(2) the procedures by which a taxpayer may appeal any adverse decision of the Service (including administrative and judicial appeals);

(3) the procedures for prosecuting refund claims and filing of taxpayer complaints; and

(4) the procedures which the Service may use in enforcing the internal revenue laws (including assessment, jeopardy assessment, levy and distraint, and enforcement of liens).

(b) TRANSMISSION TO COMMITTEES OF CONGRESS. – The Secretary of the Treasury shall transmit drafts of the statement required under subsection (a) (for proposed revisions of any such statement) to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation on the same day.

(c) DISTRIBUTION. – The statement prepared in accordance with subsections (a) and (b) shall be distributed by the Secretary of the Treasury to all taxpayers the Secretary contacts with respect to the determination or collection of any tax (other than by providing tax forms). The Secretary shall take such actions as the Secretary deems necessary to ensure that such distribution does not result in multiple statements being sent to any one taxpayer.

SEC. 6228. PROCEEDS INVOLVING TAXPAYER INTERVIEWS.

(a) IN GENERAL. – Chapter 77 of the 1986 Code (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 7520. PROCEDURES INVOLVING TAXPAYER INTERVIEWS.

"(a) RECORDING OF INTERVIEWS.–

"(1) RECORDING BY TAXPAYER. – Any officer or employee of the Internal Revenue Service in connection with any in-person interview with any taxpayer relating to the determination or collection of any tax shall, upon advance request of such taxpayer, allow the taxpayer to make an audio recording of such interview at the taxpayer's own expense and with the taxpayer's own equipment.

"(2) RECORDING OF IRS OFFICER OR EMPLOYEE. – An officer or employee of the Internal Revenue Service may record any interview described in paragraph (1) if such officer or employee–

"(A) informs the taxpayer of such recording prior to the interview, and

"(B) upon request of the taxpayer, provides the taxpayer with a transcript or copy of such recording but only if the taxpayer provides reimbursement for the cost of the transcription and reproduction of such transcript or copy.

"(b) SAFEGUARDS.–

"(1) EXPLANATIONS OF PROCESSES. – An officer or employee of the Internal Revenue Service shall before or at an initial interview provide to the taxpayer–

"(A) in the case of an in-person interview with the taxpayer relating to the determination of any tax, an explanation of the audit process and the taxpayer's rights under such process, or

"(B) in the case of an in-person interview with the taxpayer relating to the collection of any tax, an explanation of the collection process and the taxpayer's rights under such process.

"(2) RIGHT OF CONSULTATION. – If the taxpayer clearly states to an officer or employee of the Internal Revenue Service at any time during any interview (other than an interview initiated by an administrative summons issued under subchapter A of chapter 78) that the taxpayer wishes to consult with an attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the Internal Revenue Service, such officer or employee shall suspend such interview regardless of whether the taxpayer may have answered one or more questions.

"(c) REPRESENTATIVES HOLDING POWER OF ATTORNEY. – Any attorney, certified public accountant, enrolled agent, enrolled actuary, or any other person permitted to represent the taxpayer before the Internal Revenue Service who is not disbarred or suspended from practice before the Internal Revenue Service and who has a written power of attorney executed by the taxpayer may be authorized by such taxpayer to represent the taxpayer in any interview described in subsection (a). An officer or employee of the Internal Revenue Service may not require a taxpayer to accompany the representative in the absence of an administrative summons issued to the taxpayer under subchapter A of chapter 78. Such an officer or employee, with the consent of the immediate supervisor of such officer or employee, may notify the taxpayer directly that such officer or employee believes such representative is responsible for unreasonable delay or hindrance of an Internal Revenue Service examination or investigation of the taxpayer.

"(d) SECTION NOT TO APPLY TO CERTAIN INVESTIGATIONS. – This section shall not apply to criminal investigations or investigations re-

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lating to the integrity of any officer or employee of the Internal Revenue Service."

(b) REGULATIONS WITH RESPECT TO TIME AND PLACE OF EXAMINATION. – The Secretary of the Treasury or the Secretary's delegate shall issue regulations to implement subsection (a) of section 7605 of the 1986 Code (relating to time and place of examination) within 1 year after the date of the enactment of this Act.

(c) CLERICAL AMENDMENT. – The table of sections for chapter 77 of the 1986 Code is amended by adding at the end thereof the following new item:

"Sec. 7520. Procedures involving taxpayer interviews."

(d) EFFECTIVE DATE. – The amendments made by subsections (a) and (c) shall apply to interviews conducted on or after the date which is 90 days after the date of the enactment of this Act.

SEC. 6229. TAXPAYERS MAY RELY ON WRITTEN ADVICE OF INTERNAL REVENUE SERVICE.

(a) IN GENERAL. – Section 6404 of the 1986 Code (relating to abatements) is amended by adding at the end thereof the following new subsection:

"(f) ABATEMENT OF ANY PENALTY OR ADDITION TO TAX ATTRIBUTABLE TO ERRONEOUS WRITTEN ADVICE BY THE INTERNAL REVENUE SERVICE. –

"(1) IN GENERAL. – The Secretary shall abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the Internal Revenue Service, acting in such officer's or employee's official capacity.

"(2) LIMITATIONS. – Paragraph (1) shall apply only if–

"(A) the written advice was reasonably relied upon by the taxpayer and was in response to a specific written request of the taxpayer, and

"(B) the portion of the penalty or addition to tax did not result from a failure by the taxpayer to provide adequate or accurate information.

"(3) INITIAL REGULATIONS. – Within 180 days after the date of the enactment of this subsection, the Secretary shall prescribe such initial regulations as may be necessary to carry out this subsection."

(b) EFFECTIVE DATE. – The amendment made by subsection (a) shall apply with respect to advice requested on or after January 1, 1989.

SEC. 6230. TAXPAYER ASSISTANCE ORDERS.

(a) IN GENERAL. – Subchapter A of chapter 80 of the 1986 Code (relating to general rules for application of the internal revenue laws) is amended by adding at the end thereof the following new section:

"SEC. 7811. TAXPAYER ASSISTANCE ORDERS.

"(a) AUTHORITY TO ISSUE. – Upon application filed by a taxpayer with the Office of Ombudsman (in such form, manner, and at such time as the Secretary shall by regulations prescribe), the Ombudsman may issue a Taxpayer Assistance Order if, in the determination of the Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary.

"(b) TERMS OF A TAXPAYER ASSISTANCE ORDER. – The terms of a Taxpayer Assistance Order may require the Secretary–

"(1) to release property of the taxpayer levied upon, or

"(2) to cease any action, or refrain from taking any action, with respect to the taxpayer under–

"(A) chapter 64 (relating to collection),

"(B) subchapter B of chapter 70 (relating to bankruptcy and receiverships),

"(C) chapter 78 (relating to discovery of liability and enforcement of title), or

"(D) any other provision of law which is specifically described by the Ombudsman in such order.

"(c) AUTHORITY TO MODIFY OR RESCIND. – Any Taxpayer Assistance Order issued by the Ombudsman under this section may be modified or rescinded only by the Ombudsman, a district director, a service center director, a compliance center director, a regional director of appeals, or any superior of any such person.

"(d) SUSPENSION OF RUNNING OF PERIOD OF LIMITATION. – The running of any period of limitation with respect to any action described in subsection (b) shall be suspended for–

"(1) the period beginning on the date of the taxpayer's application under subsection (a) and ending on the date of the Ombudsman's decision with respect to such application, and

"(2) any period specified by the Ombudsman in a Taxpayer Assistance Order issued pursuant to such application.

"(e) INDEPENDENT ACTION OF OMBUDSMAN. – Nothing in this section shall prevent the Ombudsman from taking any action in the absence of an application under subsection (a).

"(f) OMBUDSMAN. – For purposes of this section, the term 'Ombudsman' includes any designee of the Ombudsman."

(b) CLERICAL AMENDMENT. – The table of sections for subchapter A of chapter 80 of the 1986 Code is amended by adding at the end thereof the following new item:

"Sec. 7811. Taxpayer Assistance Orders."

(c) ISSUANCE OF REGULATIONS. – The Secretary of the Treasury or the Secretary's delegate shall issue such regulations as the Secretary deems necessary within 90 days of the date of the enactment of this Act in order to carry out the purposes of section 7811 of the 1986 Code (as added by this section) and to ensure taxpayers uniform access to administrative procedures.

(d) EFFECTIVE DATE. – The amendments made by this section shall take effect on January 1, 1989.

SEC. 6231. BASIS FOR EVALUATION OF INTERNAL REVENUE SERVICE EMPLOYEES.

(a) IN GENERAL. – The Internal Revenue Service shall not use records of tax enforcement results–

(1) to evaluate employees directly involved in collection activities and their immediate supervisors, or

(2) to impose or suggest production quotas or goals with respect to individuals described in clause (i).

(b) APPLICATION OF IRS POLICY STATEMENT. – The Internal Revenue Service shall not be treated as failing to meet the requirements of subsection (a) if the Service follows the policy statement of the Service regarding employee evaluation (as in effect on the date of the enactment of this Act) in a manner which does not violate subsection (a).

(c) CERTIFICATION. – Each district director shall certify quarterly by letter to the Commissioner of the Internal Revenue that tax enforcement results are not used in a manner prohibited by subsection (a).

(d) EFFECTIVE DATE. – The provisions of this section shall apply to evaluations conducted on or after January 1, 1989.

SEC. 6232. PROCEDURES RELATING TO INTERNAL REVENUE SERVICE REGULATIONS.

(a) IN GENERAL. – Section 7805 of the 1986 Code (relating to rules and regulations) is amended by adding at the end thereof the following new subsections:

"(e) TEMPORARY REGULATIONS. –

"(1) ISSUANCE. – Any temporary regulation issued by the Secretary shall also be issued as a proposed regulation.

"(2) 3-YEAR DURATION. –. Any temporary regulation shall expire within 3 years after the date of issuance of such regulation.

"(f) IMPACT OF REGULATIONS ON SMALL BUSINESS REVIEWED. – After the publication of any proposed regulation by the Secretary and before the promulgation of any final regulation by the Secretary which does not supersede a proposed regulation, the Secretary shall submit such regulation to the Administrator of the Small Business Administration for comment on the impact of such regulation on small business. The Administrator shall have 4 weeks from the date of submission to respond."

(b) EFFECTIVE DATE. – The amendments made by this section shall apply to any regulation issued after the date which is 10 days after the date of the enactment of this Act.

SEC. 6233. CONTENT OF TAX DUE, DEFICIENCY, AND OTHER NOTICES.

(a) IN GENERAL. – Chapter 77 of the 1986 Code (relating to miscellaneous provisions) is further amended by adding at the end thereof the following new section:

"SEC. 7521. CONTENT OF TAX DUE, DEFICIENCY, AND OTHER NOTICES.

"(a) GENERAL RULE. – Any notice to which this section applies shall describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice. An inadequate description under the preceding sentence shall not invalidate such notice.

"(b) NOTICES TO WHICH SECTION APPLIES. – This section shall apply to–

"(1) any tax due notice or deficiency notice described in section 6155, 6212, or 6303,

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"(2) any notice generated out of any information return matching program, and

"(3) the 1st letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals."

(b) CLERICAL AMENDMENT. – The table of sections for chapter 77 of the 1986 Code is further amended by adding at the end thereof the following new item:

"Sec. 7521. Content of tax due, deficiency, and other notices."

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to mailings made on or after January 1, 1990.

(d) REPORT. – Not later than July 1, 1989, the Secretary of the Treasury or his delegate shall submit a report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on the steps taken to carry out the amendments made by this section.

SEC. 6234. INSTALLMENT OF TAX LIABILITY.

(a) IN GENERAL. – Subchapter A of chapter 62 of the 1986 Code (relating to place and due date for payment of tax) is amended by adding at the end thereof the following new section:

"SEC. 6159. AGREEMENTS FOR PAYMENT OF TAX LIABILITY IN INSTALLMENTS.

"(a) AUTHORIZATION OF AGREEMENTS. – The Secretary is authorized to enter into written agreements with any taxpayer under which such taxpayer is allowed to satisfy liability for payment of any tax in installment payments if the Secretary determines that such agreement will facilitate collection of such liability.

"(b) EXTENT TO WHICH AGREEMENTS REMAIN IN EFFECT. –

"(1) IN GENERAL. – Except as otherwise provided in this subsection, any agreement entered into by the Secretary under subsection (a) shall remain in effect for the term of the agreement.

"(2) INADEQUATE INFORMATION OR JEOPARDY. – The Secretary may terminate any agreement entered into by the Secretary under subsection (a) if–

"(A) information which the taxpayer provided to the Secretary prior to the date such agreement was entered into was inaccurate or incomplete, or

"(B) the Secretary believes that collection of any tax to which an agreement under this section relates is in jeopardy.

"(3) SUBSEQUENT CHANGE IN FINANCIAL CONDITIONS. –

"(A) IN GENERAL. – If the Secretary makes a determination that the financial condition of a taxpayer with whom the Secretary has entered into an agreement under subsection (a) has significantly changed, the Secretary may alter, modify, or terminate such agreement.

"(B) NOTICE. – Action may be taken by the Secretary under subparagraph (A) only if–

"(i) notice of such determination is provided to the taxpayer no later than 30 days prior to the date of such action, and

"(ii) such notice includes the reasons why the Secretary believes a significant change in the financial condition of the taxpayer has occurred.

"(4) FAILURE TO PAY AN INSTALLMENT OR ANY OTHER TAX LIABILITY WHEN DUE OR TO PROVIDE REQUESTED FINANCIAL INFORMATION. – The Secretary may alter, modify, or terminate an agreement entered into by the Secretary under subsection (a) in the case of the failure of the taxpayer–

"(A) to pay any installment at the time such installment payment is due under such agreement,

"(B) to pay any other tax liability at the time such liability is due, or

"(C) to provide a financial condition update as requested by the Secretary."

(b) CONFIRMING AMENDMENTS. –

(1) Paragraph (1) of section 6601(b) of the 1986 Code (relating to last day prescribed for payment) is amended by inserting "or any installment agreement entered into under section 6159" after "time for payment".

(2) The table of section for subchapter A of chapter 62 of the 1986 Code is amended by adding at the end thereof the following new item:

"Sec. 6159. Agreements for payment of tax liability in installments."

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to agreements entered into after the date of the enactment of this Act.

SEC. 6235. ASSISTANT COMMISSIONER FOR TAXPAYER SERVICES.

(a) IN GENERAL. – Section 7802 of the 1986 Code (relating to Commissioner of Revenue; Assistant Commissioner (Employee Plans and Exempt Organizations) is amended by adding at the end thereof the following new subsection:

"(c) ASSISTANT COMMISSIONER (TAXPAYER SERVICES). – There is established within the Internal Revenue Service an office to be known as the 'Office for Taxpayer Services' to be under the supervision and direction of an Assistant Commissioner of the Internal Revenue. The Assistant Commissioner shall be responsible for taxpayer services such as telephone, walk-in, and taxpayer educational services, and the design and production of tax and informational forms."

(b) ANNUAL REPORTS TO CONGRESS. – The Assistant Commissioner (Taxpayer Services) and the Taxpayer Ombudsman for the Internal Revenue Service shall jointly make an annual report regarding the quality of taxpayer services provided. Such report shall be made to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

(c) EFFECTIVE DATE. – The amendment made by subsection (a) shall take effect on the date 180 days after the date of the enactment of this Act.

PART II – LEVY AND LIEN PROVISIONS

SEC. 6236. LEVY AND DISTRAINT.

(a) NOTICE. – Section 6331(d) of the 1986 Code (relating to levy and distraint) is amended–

(1) by striking out "10 days" in paragraph (2) and inserting in lieu thereof "30 days",

(2) by striking out "10-DAY REQUIREMENT" in the heading of paragraph (2) and inserting in lieu thereof "30-DAY REQUIREMENT", and

(3) by adding at the end thereof the following new paragraph:

"(4) INFORMATION INCLUDED WITH NOTICE. – The notice required under paragraph (1) shall include a brief statement which sets forth in simple and nontechnical terms–

"(A) the provisions of this title relating to levy and sale of property,

"(B) the procedures applicable to the levy and sale of property under this title,

"(C) the administrative appeals available to the taxpayer with respect to such levy and sale and the procedures relating to such appeals.

"(D) the alternatives available to taxpayers which could prevent levy on the property (including installment agreements under section 6159),

"(E) the provisions of this title relating to redemption of property and release of liens on property, and

"(F) the procedures applicable to the redemption of property and the release of a lien on property under this title."

(b) EFFECT OF LEVY ON SALARY AND WAGES.–

(1) IN GENERAL – Subsection (e) of section 6331 of the 1986 Code (relating to levy and distraint) is amended to read as follows:

"(e) CONTINUING LEVY ON SALARY AND WAGES. – The effect of a levy on salary or wages payable to or received by a taxpayer shall be continuous from the date such levy is first made until such levy is released under section 6343."

(2) CROSS REFERENCE. – Section 6331(f) of the 1986 Code (relating to cross references) is amended by adding at the end thereof the following new paragraph:

"(3) For release and notice of release of levy, see section 6343."

(c) INCREASE IN AMOUNTS OF CERTAIN PROPERTY EXEMPT FROM LEVY.–

(1) FUEL, PROVISIONS, FURNITURE, PERSONAL EFFECTS. – Paragraph (2) of section 6334(a) of the 1986 Code (relating to property exempt from levy) is amended by striking out "$ 1,500" and inserting in lieu thereof "$ 1,650 ($ 1,550 in the case of levies issued during 1989)".

(2) BOOKS AND TOOLS. – Paragraph (3) of section 6334(a) of the 1986 Code is amended by striking out "$ 1,000" and inserting in lieu thereof "$ 1,100 ($ 1,050 in the case of levies issued during 1989)".

(3) WAGES, SALARY, AND OTHER INCOME.–

(A) INCREASE IN AMOUNT EXEMPT. – Paragraph (1) of section 6334(d) of the 1986 Code (relating to exempt amount of wages, salary, or other income) is amended to read as follows:

"(1) INDIVIDUALS ON WEEKLY BASIS. – In the case of an individual who is paid or receives all of his wages, salary, and other income on a weekly basis, the amount of the wages, salary, and other income payable to or received by him during any week which is exempt from levy under subsection (a)(9) shall be the exempt amount."

(B) EXEMPT AMOUNT DEFINED. – Subsection (d) of section 6334 of the 1986 Code (relating to property exempt from levy) is

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amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

"(2) EXEMPT AMOUNT. – For purposes of paragraph (1), the term 'exempt amount' means an amount equal to–

"(A) the sum of–

"(i) the standard deduction, and

"(ii) the aggregate amount of the deductions for personal exemptions allowed the taxpayer under section 151 in the taxable year in which such levy occurs, divided by

"(B) 52.

Unless the taxpayer submits to the Secretary a written and properly verified statement specifying the facts necessary to determine the proper amount under subparagraph (A), subparagraph (A) shall be applied as if the taxpayer were a married individual filing a separate return with only 1 personal exemption."

(4) ADDITIONAL PROPERTY EXEMPT FROM LEVY.–

(A) IN GENERAL. – Subsection (a) of section 6334 of the 1986 Code (relating to property exempt from levy) is amended by adding at the end thereof the following new paragraphs:

"(11) CERTAIN PUBLIC ASSISTANCE PAYMENTS. – Any amount payable to an individual as a recipient of public assistance under–

"(A) title IV (relating to aid to families with dependent children) or title XVI (relating to supplemental security income for the aged, blind, and disabled) of the Social Security Act, or

"(B) State or local government public assistance or public welfare programs for which eligibility is determined by a needs or income test.

"(12) ASSISTANCE UNDER JOB TRAINING PARTNERSHIP ACT. – Any amount payable to a participant under the Job Training Partnership Act (20 U.S.C. 1501 et seq.) from funds appropriated pursuant to such Act.

"(13) PRINCIPAL RESIDENCE EXEMPT IN ABSENCE OF CERTAIN APPROVAL OR JEOPARDY. – Except to the extent provided in subsection (e), the principal residence of the taxpayer (within the meaning of section 1034)."

(B) LEVY PERMITTED ON PRINCIPAL RESIDENCE IN CASE OF JEOPARDY OR APPROVAL BY CERTAIN OFFICIALS. – Section 6334 of the 1986 Code is amended by adding at the end thereof the following new subsection:

"(e) LEVY ALLOWED ON PRINCIPAL RESIDENCE IN CASE OF JEOPARDY OR CERTAIN APPROVAL. – Property described in subsection (a)(13) shall not be exempt from levy if–

"(1) a district director or assistant district director of the Internal Revenue Service personally approves (in writing) the levy of such property, or

"(2) the Secretary finds that the collection of tax is in jeopardy."

(d) UNECONOMICAL LEVY; LEVY ON APPEARANCE DATE OF SUMMONS. – Section 6331 of the 1986 Code (relating to levy and distraint) is amended by redesignating subsection (f) as subsection (h) and by inserting after subsection (e) the following new subsections:

"(f) UNECONOMICAL LEVY. – No levy may be made on any property if the amount of the expenses which the Secretary estimates (at the time of levy) would be incurred by the Secretary with respect to the levy and sale of such property exceeds the fair market value of such property at the time of levy.

"(g) LEVY ON APPEARANCE DATE OF SUMMONS.–

"(1) IN GENERAL. – No levy may be made on the property of any person on any day on which such person (or officer or employee of such person) is required to appear in response to a summons issued by the Secretary for the purpose of collecting any underpayment of tax.

"(2) NO APPLICATION IN CASE OF JEOPARDY. – This subsection shall not apply if the Secretary finds that the collection of tax is in jeopardy."

(e) SURRENDER OF BANK ACCOUNTS SUBJECT TO LEVY ONLY AFTER 21 DAYS.–

(1) IN GENERAL. – Section 6332 of the 1986 Code (relating to surrender of property subject to levy), as amended by title I of this Act, is amended by redesignating subsections (c), (d), and (e) as subsections (d), (e), and (f), respectively, and by inserting after subsection (b) the following new subsection:

"(c) SPECIAL RULE FOR BANKS. – Any bank (as defined in section 408(n)) shall surrender (subject to an attachment or execution under judicial process) any deposits (including interest thereon) in such bank only after 21 days after service of levy."

(2) CONFORMING AMENDMENTS.–

(A) Subsection (a) of section 6332 of the 1986 Code is amended by striking out "subsection (b)" and inserting in lieu thereof "subsections (b) and (c)"

(B) Subsection (e) of section 6332 of the 1986 Code, as redesignated by paragraph (1), is amended by striking out "subsection (c)(1)" and inserting in lieu thereof "subsection (d)(1)"

(f) RELEASE OF LEVY. – Subsection (a) of section 6343 of the 1986 Code (relating to release of levy) is amended to read as follows:

"(a) RELEASE OF LEVY AND NOTICE OF RELEASE.–

"(1) IN GENERAL. – Under regulations prescribed by the Secretary, the Secretary shall release the levy upon all, or part of, the property or rights to property levied upon and shall promptly notify the person upon whom such levy was made (if any) that such levy has been released if–

"(A) the liability for which such levy was made is satisfied or becomes unenforceable by reason of lapse of time,

"(B) release of such levy will facilitate the collection of such liability,

"(C) the taxpayer has entered into an agreement under section 6159 to satisfy such liability by means of installment payments, unless such agreement provides otherwise,

"(D) the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer, or

"(E) the fair market value of the property exceeds such liability and release of the levy on a part of such property could be made without hindering the collection of such liability.

For purposes of subparagraph (C), the Secretary is not required to release such levy if such release would jeopardize the secured creditor status of the Secretary.

"(2) EXPECTED DETERMINATION ON CERTAIN BUSINESS PROPERTY. – In the case of any tangible personal property essential in carrying on the trade or business of the taxpayer, the Secretary shall provide for an expedited determination under paragraph (1) if levy on such tangible personal property would prevent the taxpayer from carrying on such trade or business.

"(3) SUBSEQUENT LEVY. – The release of levy on any property under paragraph (1) shall not prevent any subsequent levy on such property."

(g) RIGHT OF TAXPAYER TO REQUEST THAT SEIZED PROPERTY BE SOLD WITHIN 60 DAYS. – Section 6335 of the 1986 Code (relating to sale of seized property) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) RIGHT TO REQUEST SALE OF SEIZED PROPERTY WITHIN 60 DAYS. – The owner of any property seized by levy may request that the Secretary sell such property within 60 days after such request (or within such longer period as may be specified by the owner). The Secretary shall comply with such request unless the Secretary determines (and notifies the owner within such period) that such compliance would not be in the best interests of the United States."

(h) EFFECTIVE DATE.–

(1) IN GENERAL. – The amendments made by this section (other than subsection (g)) shall apply to levies issued on or after July 1, 1989.

(2) SUBSECTION (g). – The amendment made by subsection (g) shall apply to requests made on or after January 1, 1989.

SEC. 6237. REVIEW OF JEOPARDY LEVY AND ASSESSMENT PROCEDURES.

(a) IN GENERAL. – Subsection (a)(1) of section 7429 of the 1985 Code (relating to review of jeopardy assessment procedures) is amended–

(1) by inserting "or levy is made under section 6331(a) less than 30 days after notice and demand for payment is made under section 6331(a)," after "6862,", and

(2) by inserting "or levy" after "such assessment".

(b) ADMINISTRATIVE DETERMINATIONS. – Paragraph (3) of section 7429(a) of the 1986 Code (relating to redetermination by the Secretary) is amended to read as follows:

"(3) REDETERMINATION BY SECRETARY. – After a request for review is made under paragraph (2), the Secretary shall determine–

"(A) whether or not–

"(i) the making of the assessment under section 6851, 6861, or 6862, as the case may be, is reasonable under the circumstances, and

"(ii) the amount so assessed or demanded as a result of the action taken under section 6851, 6861, or 6862 is appropriate under the circumstances, or

"(B) whether or not the levy described in subsection (a)(1) is reasonable under the circumstances."

(c) TAX COURT REVIEW JURISDICTION. – Subsection (b) of section 7429 of the 1986 Code

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is amended to read as follows:

"(b) JUDICIAL REVIEW.–

"(1) PROCEEDING PERMITTED. – Within 90 days after the earlier of–

"(A) the day the Secretary notifies the taxpayer of the Secretary's determination described is subsection (a)(3), or

"(B) the 16th day after the request described in subsection (a)(2) was made, the taxpayer may bring a civil action against the United States for a determination under this subsection in the court with jurisdiction determined under paragraph (2).

"(2) JURISDICTION FOR DETERMINATION.–

"(A) IN GENERAL. – Except as provided in subparagraph (B), the district courts of the United States shall have exclusive jurisdiction over any civil action for a determination under this subsection.

"(B) TAX COURT. – If a petition for a redetermination of a deficiency under section 6213(a) has been timely filed with the Tax Court before the making of an assessment or levy that is subject to the review procedures of this section, and 1 or more of the taxes and taxable periods before the Tax Court because of such petition is also included in the written statement that is provided to the taxpayer under subsection (a), then the Tax Court also shall have jurisdiction over any civil action for a determination under this subsection with respect to all the taxes and taxable periods included in such written statement.

"(3) DETERMINATION BY COURT. – Within 20 days after a proceeding is commenced under paragraph (1), the court shall determine–

"(A) whether or not–

"(i) the making of the assessment under section 6851, 6861, or 6862, as the case may be, is reasonable under the circumstances, and

"(ii) the amount so assessed or demanded as a result of the action taken under section 6851, 6861, or 6862 is appropriate under the circumstances, or

"(B) whether or not the levy described in subsection (a)(1) is reasonable under the circumstances.

If the court determines that proper service was not made on the United States or on the Secretary, as may be appropriate, within 5 days after the date of the commencement of the proceeding, then the running of the 20-day period set forth in the proceeding sentence shall not begin before the day on which proper service was made on the United States or on the Secretary, as may be appropriate.

"(4) ORDER OF COURT. – If the court determines that the making of such levy is unreasonable, that the making of such assessment is unreasonable, or that the amount assessed or demanded is inappropriate, then the court may order the Secretary to release such levy, to abate such assessment, to redetermine (in whole or in part) the amount assessed or demanded, or to take such other action as the court finds appropriate."

(d) VENUE. – Section 7429(e) of the 1986 Code (relating to venue) is amended to read as follows:

"(e) VENUE.–

"(1) DISTRICT COURT. – A civil action in a district court under subsection (b) shall be commenced only in the judicial district described in section 1402(a)(1) or (2) of title 28, United States Code.

"(2) TRANSFER OF ACTIONS. – If a civil action is filed under subsection (b) with the Tax Court and such court finds that there is want of jurisdiction because of the jurisdiction provisions of subsection (b)(2), then the Tax Court shall, if such court determines it is in the interest of justice, transfer the civil action to the district court in which the action could have been brought at the time such action was filed. Any civil action so transferred shall proceed as if such action had been filed in the district court to which such action is transferred on the date on which such action was actually filed in the Tax Court from which such action is transferred."

(e) CONFORMING AMENDMENTS.–

(1) Section 7429(c) of the 1986 Code (relating to extension of 20-day period where taxpayer so requests) and section 7429(f) (relating to finality of determination) are amended by striking out "district" each place it appears.

(2) Section 7429(g) of the 1986 Code (relating to burden of proof) is amended–

(A) by inserting "the making of a levy described in subsection (a)(1) or" after "whether" in paragraph (1),

(B) by striking out "TERMINATION" in the heading of paragraph (1) and inserting in lieu thereof "LEVY, TERMINATION,", and

(C) by striking out "an action" and inserting in lieu thereof "a proceeding" in paragraphs (1) and (2).

(3) The heading of section 7429 of the 1986 Code is amended by inserting "LEVY OR" after "JEOPARDY".

(4) The table of sections for subchapter B of chapter 76 of the 1986 Code is amended by inserting "levy or" after "jeopardy" in the item relating to section 7429.

(f) EFFECTIVE DATE. – The amendments made by this section shall apply to jeopardy levies issued and assessments made on or after July 1, 1989.

SEC. 6238. ADMINISTRATIVE APPEAL OF LIENS.

(a) ESTABLISHMENT OF ADMINISTRATIVE APPEAL FOR DISPUTED LIENS. – Subchapter C of chapter 64 of the 1986 Code (relating to lien for taxes) is amended by redesignating section 6326 as section 6327 and inserting after section 6325 the following new section:

"SEC. 6326. ADMINISTRATIVE APPEAL OF LIENS.

"(a) IN GENERAL. – In such form and at such time as the Secretary shall prescribe by regulations, any person shall be allowed to appeal to the Secretary after the filing of a notice of a lien under this subchapter on the property or the rights to property of such person for a release of such lien alleging an error in the filing of the notice of such lien.

"(b) CERTIFICATE OF RELEASE. – If the Secretary determines that the filing of the notice of any lien was erroneous, the Secretary shall expeditiously (and, to the extent practicable, within 14 days after such determination) issue a certificate of release of such lien and shall include in such certificate a statement that such filing was erroneous."

(b) REGULATIONS. – The Secretary of the Treasury or the Secretary's delegate shall prescribe the regulations necessary to implement the administrative appeal provided for in the amendment made by subsection (a) within 180 days after the date of the enactment of this Act.

(c) CLERICAL AMENDMENT. – The table of sections for subchapter C of chapter 64 of the 1986 Code is amended by striking out the item relating to section 6326 and inserting in lieu thereof the following:

"Sec. 6326. Administrative appeal of liens.

"Sec. 6327. Cross references."

(d) EFFECTIVE DATE. – The amendments made by this section shall take effect on the date which is 60 days after the date regulations are issued under subsection (b).

PART III – PROCEEDINGS BY TAXPAYERS

SEC. 6239. AWARDING OF COSTS AND CERTAIN FEES IN ADMINISTRATIVE AND COURT PROCEEDINGS.

(a) IN GENERAL. – Section 7430 of the 1986 Code is amended to read as follows:

"SEC. 7430. AWARDING OF COSTS AND CERTAIN FEES.

"(a) IN GENERAL. – In any administrative or court proceeding which is brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, the prevailing party may be awarded a judgment or a settlement for–

"(1) reasonable administrative costs incurred in connection with such administrative proceeding within the Internal Revenue Service, and

"(2) reasonable litigation costs incurred in connection with such court proceeding.

"(b) LIMITATIONS.–

"(1) REQUIREMENT THAT ADMINISTRATIVE REMEDIES BE EXHAUSTED. – A judgment for reasonable litigation costs shall not be awarded under subsection (a) in any court proceeding unless the court determines that the prevailing party has exhausted the administrative remedies available to such party within the Internal Revenue Service.

"(2) ONLY COSTS ALLOCABLE TO THE UNITED STATES. – An award under subsection (a) shall be made only for reasonable litigation and administrative costs which are allocable to the United States and not to any other party.

"(3) EXCLUSION OF DECLARATORY JUDGMENT PROCEEDINGS.–

"(A). IN GENERAL. – No award for reasonable litigation costs may be made under subsection (a) with respect to any declaratory judgment proceeding.

"(B) EXCEPTION FOR SECTION 501(C)(3) DETERMINATION REVOCATION PROCEEDINGS. – Subparagraph (A) shall not apply to any proceeding which involves the revocation of a determination that the organization is described in section 501(c)(3).

"(4) COSTS DENIED WHERE PARTY PREVAILING PROTRACTS PROCEEDINGS. – No award for reasonable litigation and administrative costs may be made under subsection (a) with respect to any portion of the administrative or court proceeding during which the prevailing party has unreasonably protracted such proceeding.

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"(c) DEFINITIONS. – For purposes of this section–

"(1) REASONABLE LITIGATION COSTS. – The term 'reasonable litigation costs' includes–

"(A) reasonable court costs, and

"(B) based upon prevailing market rates for the kind or quality of services furnished–

"(i) the reasonable expenses of expert witnesses in connection with a court proceeding, except that no expert witness shall be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the United States,

"(ii) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and

"(iii) reasonable fees paid or incurred for the services of attorneys in connection with the court proceeding, except that such fees shall not be in excess of $75 per hour unless the court determines that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys for such proceeding, justifies a higher rate.

"(2) REASONABLE ADMINISTRATIVE COSTS.– The term 'reasonable administrative costs' means–

"(A) any administrative fees or similar charges imposed by the Internal Revenue Service, and

"(B) expenses, costs, and fees described in paragraph (1)(B), except that any determination made by the court under clause (ii) or (iii) thereof shall be made by the Internal Revenue Service in cases where the determination under paragraph (4)(B) of the awarding of reasonable administrative costs is made by the Internal Revenue Service.

Such term shall only include costs incurred on or after the earlier of (i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Office of Appeals, or (ii) the date of the notice of deficiency.

"(3) ATTORNEY'S FEES. – For purposes of paragraphs (1) and (2), fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court or before the Internal Revenue Service shall be treated as fees for the services of an attorney.

"(4) PREVAILING PARTY.–

"(A) IN GENERAL. – The term 'prevailing party' means any party in any proceeding to which subsection (a) applies (other than the United States or any creditor of the taxpayer involved)–

"(i) which establishes that the position of the United States in the proceeding was not substantially justified,

"(ii) which–

"(I) has substantially prevailed with respect to the amount in controversy, or

"(II) has substantially prevailed with respect to the most significant issue or set of issues presented, and

"(iii) which meets the requirements of the 1st sentence of section 2412(d)(1)(B) of title 28, United States Code (as in effect on October 22, 1986) except to the extent differing procedures are established by rule of court and meets the requirements of section 2412(d)(2)(B) of such title 28 (as so in effect).

"(B) DETERMINATION AS TO PREVAILING PARTY. – Any determination under subparagraph (A) as to whether a party is a prevailing party shall be made by agreement of the parties or–

"(i) in the case where the final determination with respect to the tax, interest, or penalty is made at the administrative level, by the Internal Revenue Service, or

"(ii) in the case where such final determination is made by a court, the court.

"(5) ADMINISTRATIVE PROCEEDINGS. – The term 'administrative proceeding' means any procedure or other action before the Internal Revenue Service.

"(6) COURT PROCEEDINGS. – The term 'court proceeding' means any civil action brought in a court of the United States (including the Tax Court and the United States Claims Court).

"(7) POSITION OF UNITED STATES. – The term 'position of the United States' means–

"(A) the position taken by the United States in a judicial proceeding to which subsection (a) applies, and

"(B) the position taken in an administrative proceeding to which subsection (a) applies as of the earlier of–

"(i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Office of Appeals, or

"(ii) the date of the notice of deficiency.

"(d) SPECIAL RULES FOR PAYMENT OF COSTS.–

"(1) REASONABLE ADMINISTRATIVE COSTS. – An award for reasonable administrative costs shall be payable out of funds appropriated under section 1304 of title 31, United States Code.

"(2) REASONABLE LITIGATION COSTS. – An award for reasonable litigation costs shall be payable in the case of the Tax Court in the same manner as such an award by a district court.

"(e) MULTIPLE ACTIONS. – For purposes of this section, in the case of–

"(1) multiple actions which could have been joined or consolidated, or

"(2) a case or cases involving a return or returns of the same taxpayer (including joint returns of married individuals) which could have been joined in a single court proceeding in the same court, such actions or cases shall be treated as 1 court proceeding regardless of whether such joinder or consolidation actually occurs, unless the court in which such action is brought determines, in its discretion, that it would be inappropriate to treat such actions or cases as joined or consolidated.

"(f) RIGHT OF APPEAL.–

"(1) COURT PROCEEDINGS. – An order granting or denying (in whole or in part) an award for reasonable litigation or administrative costs under subsection (a) in a court proceeding, may be incorporated as a part of the decision or judgment in the court proceeding and shall be subject to appeal in the same manner as the decision or judgment.

"(2) ADMINISTRATIVE PROCEEDINGS. – A decision granting or denying (in whole or in part) an award for reasonable administrative costs under subsection (a) by the Internal Revenue Service shall be subject to appeal to the Tax Court under rules similar to the rules under section 7463 (without regard to the amount in dispute)."

(b) CONFORMING AMENDMENT. – Section 504 of title 5, United States Code, is amended by adding at the end thereof the following new subsection:

"(f) No award may be made under this section for costs, fees, or other expenses which may be awarded under section 7430 of the Internal Revenue Code of 1986."

(c) CLERICAL AMENDMENT. – The table of sections for subchapter B of chapter 76 of the 1986 Code is amended by striking out "court" in the item relating to section 7430.

(d) EFFECTIVE DATE. – The amendments made by this section shall apply to proceedings commencing after the date of the enactment of this Act.

SEC. 6240. CIVIL CAUSE OF ACTION FOR DAMAGES SUSTAINED DUE TO FAILURE TO RELEASE LIEN.

(a) IN GENERAL. – Subchapter B of chapter 76 of the 1986 Code (relating to proceedings by taxpayers and third parties) is amended by redesignating section 7432 as section 7433 and by inserting after section 7431 the following new section:

"SEC. 7432. CIVIL DAMAGES FOR FAILURE TO RELEASE LIEN.

"(a) IN GENERAL. – If any officer or employee of the Internal Revenue Service knowingly, or by reason of negligence, fails to release a lien under section 6325 on property of the taxpayer, such taxpayer may bring a civil action for damages against the United States in a district court of the United States.

"(b) DAMAGES. – In any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of–

"(1) actual, direct economic damages sustained by the plaintiff which, but for the actions of the defendant, would not have been sustained, plus

"(2) the costs of the action.

"(c) PAYMENT AUTHORITY. – Claims pursuant to this section shall be payable out of funds appropriated under section 1304 of title 31, United States Code.

"(d) LIMITATIONS.–

"(1) REQUIREMENT THAT ADMINISTRATIVE REMEDIES BE EXHAUSTED. – A judgment for damages shall not be awarded under subsection (b) unless the court determines that the plaintiff has exhausted the administrative remedies available to such plaintiff within the Internal Revenue Service.

"(2) MITIGATION OF DAMAGES. – The amount of damages awarded under subsection (b)(1) shall be reduced by the amount of such damages which could have reasonably been mitigated by the plaintiff.

"(3) PERIOD FOR BRINGING ACTION. – Notwithstanding any other provision of law, an action to enforce liability created under this section may be brought without regard to the amount in controversy and may be brought only within 2 years after the date the right of action accrues.

"(e) NOTICE OF FAILURE TO RELEASE LIEN. – The Secretary shall by regulation prescribe reasonable procedures for a taxpayer to notify the Secretary of the failure to release a lien under section 6325 on property of the taxpayer."

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"(b) CLERICAL AMENDMENT. – The table of sections for subchapter B of chapter 76 of the 1986 Code is amended by striking out the item relating to section 7432 and inserting in lieu thereof the following new items:

"Sec. 7432. Civil damages for failure to release lien.

"Sec. 7433. Cross references."

"(c) EFFECTIVE DATE. – The amendments made by this section shall apply to notices provided by the taxpayer of the failure to release a lien, and damages arising, after December 31, 1988.

SEC. 6241. CIVIL CAUSE OF ACTION FOR DAMAGES SUSTAINED DUE TO CERTAIN UNAUTHORIZED ACTIONS BY INTERNAL REVENUE SERVICE.

(a) IN GENERAL. – Subchapter B of chapter 76 of the 1986 Code (relating to proceedings by taxpayers and third parties) is further amended by redesignating section 7433 as section 7434 and by inserting after section 7432 the following new section:

"SEC. 7433. CIVIL DAMAGES FOR CERTAIN UNAUTHORIZED COLLECTION ACTIONS.

"(a) IN GENERAL. – If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

"(b) DAMAGES. – In any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the lesser of $ 100,000 or the sum of–

"(1) actual, direct economic damages sustained by the plaintiff as a proximate result of the reckless or intentional actions of the officer or employee, and

"(2) the costs of the action.

"(c) PAYMENT AUTHORITY. – Claims pursuant to this section shall be payable out of funds appropriated under section 1304 of title 31, United States Code.

"(d) LIMITATIONS.–

"(1) REQUIREMENT THAT ADMINISTRATIVE REMEDIES BE EXHAUSTED. – A judgment for damages shall not be awarded under subsection (b) unless the court determines that the plaintiff has exhausted the administrative remedies available to such plaintiff within the Internal Revenue Service.

"(2) MITIGATION OF DAMAGES. – The amount of damages awarded under subsection (b)(1) shall be reduced by the amount of such damages which could have reasonably been mitigated by the plaintiff.

"(3) PERIOD FOR BRINGING ACTION. – Notwithstanding any other provision of law, an action to enforce liability created under this section may be brought without regard to the amount in controversy and may be brought only within 2 years after the date the right of action accrues.

(b) DAMAGES FOR FRIVOLOUS OR GROUNDLESS CLAIMS.–

(1) IN GENERAL. – Section 6673 of the 1986 Code (relating to damages assessable for instituting proceedings before the Tax Court primarily for delay, etc.) is amended by inserting "(a) IN GENERAL. –" before "Whenever" and by adding at the end thereof the following new subsection:

"(b) CLAIMS UNDER SECTION 7433. – Whenever it appears to the court that the taxpayer's position in proceedings before the court instituted or maintained by such taxpayer under section 7433 is frivolous or groundless, damages in an amount not in excess of $10,000 shall be awarded to the United States by the court in the court's decision. Damages so awarded shall be assessed at the same time as the decision and shall be paid upon notice and demand from the Secretary.

(2) CLERICAL AMENDMENT. – The heading for section 6673 of the 1986 Code is amended by striking out "TAX".

(c) CLERICAL AMENDMENT. – The table of sections for subchapter B of chapter 76 of the 1986 Code is further amended by striking out the item relating to section 7433 and inserting in lieu thereof the following new items:

"SEC. 7433. CIVIL DAMAGES FOR CERTAIN UNAUTHORIZED COLLECTION ACTIONS.

"SEC. 7434. CROSS REFERENCES."

(d) EFFECTIVE DATE. – The amendments made by this section shall apply to actions by officers or employees of the Internal Revenue Service after the date of the enactment of this Act.

SEC. 6242. ASSESSABLE PENALTY FOR IMPROPER DISCLOSURE OR USE OF INFORMATION BY PREPARERS OF RETURNS.

(a) IN GENERAL. – Part I of subchapter B of chapter 68 of the 1986 Code (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"*SEC. 6712.* DISCLOSURE OR USE OF INFORMATION BY PREPARERS OF RETURNS.

"(a) IMPOSITION OF PENALTY. – If any person who is engaged in the business or preparing or providing services in connection with the preparation of, returns of tax imposed by chapter 1, or any person who for compensation prepares any such return for any other person, and who–

"(1) discloses any information furnished to him for, or in connection with, the preparation of any such return, or

"(2) uses any such information for any purpose other than to prepare, or assist in preparing, any such return, shall pay a penalty of $ 250 for each such disclosure or use, but the total amount imposed under this subsection on such a person for any calendar year shall not exceed $ 10,000.

"(b) EXCEPTIONS. – The rules of section 7216(b) shall apply for purposes of this section.

"(c) DEFICIENCY PROCEDURES NOT TO APPLY. – Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assessment or collection of any penalty imposed by this section."

(b) CRIMINAL PENALTY TO APPLY ONLY WHERE KNOWING OR RECKLESS DISCLOSURE OR USE. – The material preceding paragraph (1) of section 7216(a) of the 1986 Code is amended by striking out "and who–" and inserting in lieu thereof "and who knowingly or recklessly–".

(c) CLERICAL AMENDMENT. – The table of sections for part 1 of subchapter B of chapter 68 of the 1986 Code is amended by adding at the end thereof the following new item:

"Sec. 6712. Disclosure or use of information by preparers of returns."

(d) EFFECTIVE DATE. – The amendments made by this section shall apply to disclosures or uses after December 31, 1988.

PART IV – TAX COURT JURISDICTION

SEC. 6243. JURISDICTION TO RESTRAIN CERTAIN PREMATURE ASSESSMENTS.

(a) IN GENERAL. – Section 6213(a) of the 1986 Code (relating to time for filing petition and restriction on assessment) is amended by striking out the period at the end of the last sentence and inserting in lieu thereof ", including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action or proceeding under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition."

(b) APPEAL OF ORDER RESTRAINING ASSESSMENT, ETC. – Section 7482(a) of the 1986 Code (relating to jurisdiction on appeal) is amended by adding at the end thereof the following new paragraph:

"(3) CERTAIN ORDERS ENTERED UNDER SECTION 6213(a). –An order of the Tax Court which is entered under authority of section 6213(a) and which resolves a proceeding to restrain assessment or collection shall be treated as a decision of the Tax Court for purposes of this section and shall be subject to the same review by the United States Court of Appeals as a similar order of a district court."

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to orders entered after the date of the enactment of this Act.

SEC. 6244. JURISDICTION TO ENFORCE OVERPAYMENT DETERMINATIONS.

(a) IN GENERAL. – Section 6512(b) of the 1986 Code (relating to overpayment determined by the Tax Court) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (3)" in paragraph (1), by redesignating paragraph (2) as paragraph (3), and by inserting the following new paragraph after paragraph (1):

"(2) JURISDICTION TO ENFORCE. – If, after 120 days after a decision of the Tax Court has become final, the Secretary has failed to refund the overpayment determined by the Tax Court, together with the interest thereon as provided in subchapter B of chapter 67, then the Tax Court, upon mo-

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tion by the taxpayer, shall have jurisdiction to order the refund of such overpayment and interest."

(b) AMENDMENTS ADDING CROSS REFERENCES.–

(1) Section 6214(e) of the 1986 Code is amended by striking out "REFERENCE.-" and inserting in lieu thereof "REFERENCES.-" in the heading, by designating the undesignated paragraph as paragraph (1), and by adding at the end thereof the following new paragraph:

"(2) For provision giving Tax Court jurisdiction to order a refund of an overpayment and to award sanctions, see section 6512(b)(2)."

(2) Section 6512(c) of the 1986 Code is amended by striking out "REFERENCE.-" and inserting in lieu thereof "REFERENCES.-" in the heading, by designating the undesignated paragraph as paragraph (1), and by adding at the end thereof the following new paragraph:

"(2) For provision giving the Tax Court jurisdiction to award reasonable litigation costs in proceedings to enforce an overpayment determined by such court, see section 7430."

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to overpayments determined by the Tax Court which have not yet been refunded by the 90th day after the date of the enactment of this Act.

SEC. 6245. JURISDICTION TO REVIEW CERTAIN SALES OF SEIZED PROPERTY.

(a) JURISDICTION TO REVIEW CERTAIN SALES OF PROPERTY. – Section 6863(b)(3) of the 1986 Code (relating to stay of sale of seized property pending Tax Court decision) is amended by adding at the end thereof the following new subparagraph:

"(C) REVIEW BY TAX COURT. – If, but for the application of subparagraph (B), a sale would be prohibited by subparagraph (A)(iii), then the Tax Court shall have jurisdiction to review the Secretary's determination under subparagraph (B) that the property may be sold. Such review may be commenced upon motion by either the Secretary or the taxpayer. An order of the Tax Court disposing of a motion under this paragraph shall be reviewable in the same manner as a decision of the Tax Court."

(b) EFFECTIVE DATE. – The amendments made by this section shall take effect on the 90th day after the date of the enactment of this Act.

SEC. 6246. JURISDICTION TO REDETERMINE INTEREST ON DEFICIENCIES.

(a) IN GENERAL. – Section 7481 of the 1986 Code (relating to date when Tax Court decision becomes final) is amended by adding at the end thereof the following new subsection:

"(c) JURISDICTION OVER INTEREST DETERMINATIONS. – Notwithstanding subsection (a), if–

"(1) an assessment has been made by the Secretary under section 6215 which includes interest as imposed by this title,

"(2) the taxpayer has paid the entire amount of the deficiency plus interest claimed by the Secretary, and

"(3) within 1 year after the date the decision of the Tax Court becomes final under subsection (a), the taxpayer files a petition in the Tax Court for a determination that the amount of interest claimed by the Secretary exceeds the amount of interest imposed by this title,

then the Tax Court may reopen the case solely to determine whether the taxpayer has made an overpayment of such interest and the amount of any such overpayment. If the Tax Court determines under this subsection that the taxpayer has made an overpayment of interest, then that determination shall be treated under section 6512(b)(1) as a determination of an overpayment of tax. An order of the Tax Court redetermining the interest due, when entered upon the records of the court, shall be reviewable in the same manner as a decision of the Tax Court."

(b) CONFORMING AMENDMENTS.–

(1) Section 6512(a) of the 1986 Code (relating to effect of petition to Tax Court) is amended by inserting after "section 6213(a)" the following: "(or 7481(c) with respect to a determination of statutory interest)".

(2) Subsection (a) of section 7481 of the 1986 Code is amended by striking out "subsection (b)" and inserting in lieu thereof "subsections (b) and (c)".

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to assessments of deficiencies redetermined by the Tax Court made after the date of the enactment of this Act.

SEC. 6247. JURISDICTION TO MODIFY DECISIONS IN CERTAIN ESTATE TAX CASES.

(a) IN GENERAL. – Section 7481 of the 1986 Code (relating to date when Tax Court decision becomes final), as amended by section 783(a), is further amended by adding at the end thereof the following new subsection:

"(d) DECISIONS RELATING TO ESTATE TAX EXTENDED UNDER SECTION 6166. – If with respect to a decedent's estate subject to a decision of the Tax Court–

"(1) the time for payment of an amount of tax imposed by chapter 11 is extended under section 6166, and

"(2) there is treated as an administrative expense under section 2053 either–

"(A) any amount of interest which a decedent's estate pays on any portion of the tax imposed by section 2001 on such estate for which the time of payment is extended under section 6166, or

"(B) interest on any estate, succession, legacy, or inheritance tax imposed by a State on such estate during the period of the extension of time for payment under section 6166,

then, upon a motion by the petitioner in such case in which such time for payment of tax has been extended under section 6166, the Tax Court may reopen the case solely to modify the Court's decision to reflect such estate's entitlement to a deduction for such administration expenses under section 2053 and may hold further trial solely with respect to the claim for such deduction if, within the discretion of the Tax Court, such a hearing is deemed necessary. An order of the Tax Court disposing of a motion under this subsection shall be reviewable in the same manner as a decision of the Tax Court, but only with respect to the matters determined in such order."

(b) CONFORMING AMENDMENTS.–

(1) Section 6512(a) of the 1986 Code (relating to effect of petition to Tax Court), as amended by this part, is further amended by striking out "interest)" and inserting in lieu thereof "interest or section 7481(d) solely with respect to a determination of estate tax by the Tax Court)".

(2) Subsection (a) of section 7481 of the 1986 Code, as amended by this part, is further amended by striking out "subsections (b) and (c)" and inserting in lieu thereof "subsections (b), (c) and (d)".

(c) EFFECTIVE DATE. – The amendments made by this section shall be effective with respect to Tax Court cases for which the decision is not final on the date of the enactment of this Act.

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J.A. Stacey und W.J. Strain:

Investieren in Kanada *55*
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J. Scott Wilkie:

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Steuerabkommen auf dem Gebiet vom Einkommen), der im Allgemeinen ab 1983 in Kraft trat. Dieses Gesetz bestimmt, im Hinblick auf kanadische föderale Steuern vom Einkommen, auf welche Weise wichtige Fragen der kanadischen Steuerabkommen gelöst werden müssen.

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Howard J. Kellough:

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Stephen Edge:

Die britischen Ansichten betreffs Massnahmen zur Bekämpfung der Steuerumgehung 82
Die traditionelle britische Lösung der Steuerumgehungsproblematik war in der Vergangenheit immer, durch besondere Gesetzesbestimmungen die Lücke in der Steuergesetzgebung auszufüllen oder bestimmte Missbräuche zu beseitigen (z.B. die sogenannte „controlled foreign corporations"-Gesetzgebung, §§ 765-767 des Income and Corporations Taxes Act 1988). Seit 1981 jedoch spielen die Gerichtshöfe ebenfalls eine Rolle in der Entwicklung der Steuerumgehungsgesetze. Vorher legten diese Gerichtshöfe, wenn sie mit potentiellen Steuerumgehungsfällen konfrontiert wurden, mehr Wert auf die juristische Form, in der bestimmte Rechtshandlungen präsentiert wurden, als auf deren wesentliche Bedeutung. Sie haben jedoch diese Position geändert, wie eine Reihe von Urteilen während der letzten 7 Jahre beweist. Herr Edge beschreibt eine Anzahl dieser wichtigen Urteile.

N.J. Prentice:

Vereinigtes Königreich: Paragrafen 765-767 und „Controlled Foreign Companies" - Gesetzgebung 84
Herr Prentice beschreibt im Kurzen die wichtigsten Merkmale und Konzequenzen der §§ 765-767 des Income and Corporation Taxes Act 1988 (Einkommensteuer und Körperschaftsteuergesetz 1988), welche anordnen, dass bestimmte Aktien- und Darlehengeschäfte eine vorangehende Genehmigung der Steuerbehörden benötigen. Er befasst sich auch mit der Gesetzgebung bezüglich einer „controlled foreign company" (ausländische Gesellschaft, die von einer inländischen Gesellschaft beherrscht wird), die 1984 verabschiedet wurde.

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Investment in Canada

J.A. Stacey and W.J. Strain*

I. STRUCTURAL ALTERNATIVES

A. Forms of business organization

Business operations in Canada are essentially all carried on in one of 3 forms: corporations, partnerships or joint ventures.

A corporation is a separate legal entity and is subject to tax as such. Effective rates of Canadian corporation tax range from about 38% to 45%.

Partnerships are not taxable entities. However, the income of a partnership is calculated as if the partnership were a separate taxpayer. At the end of the partnership's fiscal year, all income is allocated to the partners and included in the partner's income, whether or not received. The source of income retains its identity (as business income, dividends, etc.) as it flows through the partnership to each partner.

Joint ventures are taxed differently. Each participant in the venture determines his income separately based on his ownership interest in the joint venture. This type of arrangement is common in real estate and the resource industries. The distinction between a joint venture and a partnership may be difficult to determine in particular circumstances. Care should be taken in drafting the relevant legal documents to ensure that the desired characterization of the relationship as a joint venture or partnership is obtained.

Regardless of the form of business organization, the U.K. investor has the basic choice of carrying on business in Canada directly through a branch or through the vehicle of a Canadian subsidiary established for the purpose. The effective rate of Canadian tax on repatriated earnings should be roughly the same whether the business is conducted through a branch or subsidiary (see Appendix A). However, other factors may result in a preference for using a branch or subsidiary.

1. Branch vs. subsidiary

Advantages of carrying on business in Canada as a branch of the U.K. corporation include:

- losses incurred by the Canadian branch are available for immediate offset against taxable profits of the U.K. corporation;
- the U.K. corporation is eligible for exemption from the "branch tax" on the first C$ 500,000 (or £ 250,000, whichever is greater) of earnings repatriated to the United Kingdom (Art. 22(4) of the Canada/United Kingdom Treaty);
- business assets of the branch might be removed from Canada without triggering Canadian tax on accrued capital gains;
- the deduction of interest costs relative to the financing of the Canadian business operation generally is not restricted by the Canadian thin-capitalization rules. However, interest on financing that is provided by the U.K. company to its Canadian branch is only deductible in determining branch income for Canadian tax purposes where the interest represents a reasonable allocation of interest actually incurred by the U.K. company on its related borrowings. Interest paid to non-residents of Canada that is deductible in calculating the taxable income of the Canadian branch may be subject to Canadian withholding tax (Subsec. 212(13.2) of the Income Tax Act ("ITA"));
- lower costs of organization and administration.

Advantages of carrying on business in Canada through a Canadian subsidiary include:

- limited liability protection;
- increased flexibility to minimize Canadian tax through reasonable inter-company charges for financing, technology transfer, inventory transfer and management fees. Charges for interest, rents and royalties generally are subject to withholding tax at 10% but are deductible in determining the subsidiary's income for Canadian tax purposes;
- increased flexibility with respect to the timing of repatriation of profits and related incidence of Canadian withholding tax;
- lower provincial capital taxes;
- lower taxes on an ultimate sale of the Canadian business operation. A sale of branch assets will likely result in the realization of taxable capital gains, recaptured depreciation and inventory profits subject to tax in Canada. In addition, the accumulated earnings of the Canadian branch are subject to the 10% branch tax upon the sale of the Canadian business operations and repatriation of the funds to the United Kingdom. A sale of the shares of the Canadian subsidiary, however, would

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likely be fully exempt from the imposition of Canadian tax (Art. 13 of the Treaty);
- increased access to Canadian federal and provincial government incentives and possible commercial benefits arising from having a Canadian identity.

2. Financing a Canadian subsidiary

Financing of the Canadian subsidiary by the U.K. parent will basically be in the form of either interest-bearing debt or equity, although lease financing may also be appropriate in certain circumstances.

One of the basic principles in the design of the Canadian income tax system is that a corporation can return a shareholder's invested capital at any time and before making any distribution of corporate earnings. This principle is in stark contrast to that of the U.S. tax system, where, regardless of the form or manner of distribution, a dollar distributed by a corporation to its shareholders is considered first to be a distribution of earnings taxable as a dividend. A variety of tax-planning opportunities are available whereby foreign shareholders can recover the cost of their investment before being subject to Canadian withholding tax on any accumulated earnings.

"Paid-up capital" (para. 89(1)(b)) is the measure of the amount contributed to the company by shareholders and consequently is the amount that can be returned to shareholders without being considered to be a dividend distribution. Amounts paid by a corporation to its shareholders as a reduction of their paid-up capital or in consideration for the redemption or acquisition of their shares or in the course of liquidating the company, to the extent that such amounts do not exceed the paid-up capital of the shares, are treated as either sale proceeds, where the shareholder has disposed of his shares, or a reduction in the shareholder's tax basis, where the shareholder continues to hold the shares. Distributions to shareholders in excess of the reduction in the paid-up capital of the corporation are treated as dividend payments (Sec. 84).

Paid-up capital is essentially a simple concept. The paid-up capital of a class of shares of a corporation is the fair value of the consideration for which those shares were issued. However, several anti-avoidance measures in the Canadian Income Tax Act will require reductions in the paid-up capital of shares in circumstances where accumulated earnings might otherwise be converted into paid-up capital without the payment of any tax.

Payments made by a Canadian public corporation (generally a corporation whose shares are listed on a prescribed stock exchange in Canada) as a reduction of the public company's paid-up capital (other than on a redemption, acquisition or cancellation of shares, winding up or reorganization) are deemed to be a distribution of dividends subject to the normal rates of non-resident withholding tax (Subsec. 84(4.1.)).

Dividends paid, or deemed to be paid, by a Canadian corporation to a U.K. resident shareholder will be subject to non-resident withholding tax at the rate of 10% provided that the recipient is a company which controls directly or indirectly at least 10% of the voting power of the company paying the dividend. The withholding rate on portfolio dividends is 15% (Art. 10 of the Treaty).

Dividends paid are not deductible in determining the taxable income of the Canadian income.

Generally any transaction that results in the capitalization of earnings into paid-up capital is deemed to be a dividend for Canadian tax purposes. However, a recent amendment to the Canadian Income Tax Act will permit the conversion into paid-up capital of a class of shares any contributed surplus of the corporation that arose on the issuance of such shares after 31 March 1977 (other than an issuance to which certain special provisions of the Act applied) (para. 84(1)(c.3)).

A Canadian corporation paying dividends on certain preferred shares may be liable to pay a tax of 25%, 40% or 66⅔% of the amount of such dividends in specified circumstances. These special taxes on dividends recently introduced into the Canadian income tax system are broadly the equivalent of an advance corporation tax imposed on dividends paid on preferred shares that are used essentially as a substitute for debt finance (Part VI.1).

Dividends paid to a shareholder which has a substantial interest (generally an interest of 25% or more) are not subject to these special taxes on preferred share dividends.

3. Debt financing

Interest on money borrowed to earn income from business or property is generally deductible in determining income for Canadian tax purposes (para. 20(1)(c)). Specific statutory provisions require that there must be a legal obligation to pay interest and the amount must be reasonable in order for the interest expense to be deductible.

Recent court decisions have cast some doubt on the deductibility of interest where borrowed funds have been used only indirectly in the income-earning process.[1] Legislative amendments have been proposed to clarify that interest will continue to be deductible where money has been borrowed to pay dividends and redeem share capital in specific circumstances. However, such provisions are expected to be in force only until the end of 1989. More fundamental changes to the rules for interest deductibility are expected to be introduced, effective in 1990.

Interest is generally deductible on the accrual basis. However, amounts owing to non-arm's length parties will be added back to taxable income unless such amounts are paid generally by the end of the second taxation year following the year in which the expense was incurred. The non-arm's length parties can avoid

1. *The Queen v. Phyllis Barbara Bronfman Trust,* 87 Dominion Tax Cases ("D.T.C.") 5059.

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the application of this provision provided an agreement is filed with Revenue Canada to the effect that the amount of unpaid interest is deemed to be paid and reloaned on the first day of the third taxation year following that in which the expense is incurred (Sec. 78).

Interest paid to a resident of the United Kingdom is generally subject to withholding tax at the rate of 10%. The withholding tax applies at the time the interest is paid or credited to the non-resident. Where an election is filed pursuant to Sec. 78, the liability for withholding tax arises at the time the interest is deemed to be paid (Subsec. 212(1)) (Art. 11 of the Treaty).

A variety of exemptions from non-resident withholding tax on interest are available but generally relate to government and government-guaranteed obligations, and interest on amounts owing to arm's length parties in particular circumstances. The most commonly used exemption is in respect of indebtedness issues where, under the terms of the obligation, the issuer may not under any circumstances be obliged to repay more than 25% of the principal within 5 years from the date of issue (para. 212(1)(b)).

Interest paid on debts held by specified non-resident shareholders (generally a shareholder who, together with related parties, owns 25% or more of the issued shares of any class of the capital stock of the corporation) is disallowed to the extent that the total debts to such non-residents exceed 3 times the equity of the debtor corporation (Subsec. 18(4)).

For purposes of the thin capitalization rules, equity is computed as:

- retained earnings at the commencement of the relevant taxation year,
- contributed surplus (by the specified non-resident shareholder) at the commencement of the year, and
- the greater of the paid-up capital at the commencement or at the end of the particular year (excluding the paid-up capital of shares owned by shareholders other than the specified non-resident shareholders).

A variety of specific anti-avoidance provisions exist to prevent the use of back-to-back loans or other arrangements with independent financial institutions which are designed to avoid the application of either the thin capitalization restrictions or the imposition of non-resident withholding tax. Particular strategies that may not be caught by the specific anti-avoidance provisions may be subject to challenge under Canada's new general anti-avoidance rule (GAAR) (Subsec. 245(2)).

For comparisons of the after-tax cost of debt financing to a U.K. company using a variety of corporate structures, see Appendix B.

4. Incorporation of a branch

A U.K. company will generally be able to incorporate a Canadian branch by transferring the branch assets on a tax-deferred basis into a newly-established Canadian subsidiary corporation in exchange for shares of the subsidiary (Subsec. 85(1)).

Provided that appropriate elections are filed on a timely basis, the proceeds of disposition of assets to the U.K. company and the cost of those assets to the Canadian company can be fixed at their tax basis. This avoids the recognition of any gain provided that the total amount of debt assumed and other non-share consideration issued by the subsidiary does not exceed the aggregate tax value of the assets transferred. The cost of the shares of the subsidiary will be determined as the aggregate of the tax values of the assets less the amount of any debt assumed and other non-share consideration issued.

Upon the incorporation of the new branch, the U.K. company is exposed to the potential imposition of branch tax on the accumulated earnings of the branch which have been reinvested in Canada and not previously subject to the branch tax. However, the imposition of the branch tax can be avoided if the aggregate of the debt assumed, non-share consideration issued and the paid-up capital of the shares issued by the subsidiary reflects only the capital invested in the branch by the U.K. company and does not reflect the amount of any reinvested earnings. Ordinarily, it should be possible to fix the paid-up capital of any shares issued on the incorporation of the branch to achieve this result (Sec. 219).

II. ACQUISITION OF CANADIAN TARGET COMPANY

A. Structuring the acquisition

In structuring the acquisition of a Canadian target company (Canco), it is important that the equity provided by the U.K. company ("U.K. Co.") be captured as paid-up capital (PUC) for Canadian tax purposes.

High PUC is important:

- to facilitate repatriation of earnings back to the United Kingdom at low or no cost;
- to avoid dividend withholding tax applicable to non-arm's length dispositions of Canco; and
- to increase the equity base to maximize interest expense deductions under the thin capitalization rules.

B. Repatriation of earnings

Where Canco distributes its surplus to U.K. Co., any distribution in excess of its PUC is considered to be a dividend and hence subject to non-resident withholding tax. Distribution of PUC to the U.K. Co. is not subject to non-resident withholding tax. Therefore, from a purely Canadian perspective, it is in the interest of the group that the U.K. funded acquisition price be represented by PUC in order to reduce the non-resident withholding. Of course, the value of this benefit is dependent on U.K. Co.'s ability to claim a foreign

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tax credit for the withholding tax in calculating its U.K. tax liability.

For example, assume that U.K. Co. acquires all of the shares of Canco directly for their fair value of $ 1,000. The PUC of the shares is $ 100. If U.K. Co. wishes to remove assets from Canco in any manner whatever, the maximum distribution not subject to non-resident tax is $ 100.

C. Anti-avoidance

Absent certain anti-avoidance rules, a corporate restructuring could be used to increase the tax-free extraction of surplus up to the full purchase price of the shares of Canco.

Assume the shares of Canco are sold by U.K. Co. to a newly-incorporated Canadian subsidiary of the U.K. company ("CanHoldco") for share consideration with a PUC of $ 1,000. A dividend from Canco to CanHoldco is not subject to tax (Subsec. 112(1)) and the same funds can be repatriated without withholding tax by means of a legal reduction of PUC or a similar redemption or repurchase of the shares of CanHoldco held by U.K. Co.

Sec. 212.1 of the ITA prevents this type of transaction by reducing the PUC of CanHoldco for tax purposes by $ 900 to $ 100, being the same PUC as that of Canco. As a result, the amount that can be distributed by CanHoldco free of withholding tax is restricted to the PUC of the Canco shares and neither pre-acquisition nor post-acquisition earnings of Canco can be repatriated without withholding tax.

Specifically, Sec. 212.1 will apply in circumstances where U.K. Co.:
- disposes of shares in Canco;
- in a transaction after 10 April 1978;
- to a corporation with which it is not dealing at arm's length; and
- Canco is connected with the purchaser corporation ("CanHoldco") after the transfer (i.e. CanHoldco owns more than 10% of all the voting shares of Canco and more than 10% of the fair market value of all the issued shares of Canco).

Where in such a transaction U.K. Co. receives non-share consideration (e.g. cash, debt securities, etc.) U.K. Co. is deemed to have received a dividend equal to the difference between the fair market value of the non-share consideration and the PUC of the shares (para. 212.1(1)(a)). The deemed dividend is subject to non-resident withholding tax (Subsec. 212(2)) of 25% which is reduced under the Treaty to 10%.

Where in such a transaction U.K. Co. takes back shares in CanHoldco, para. 212.1(1)(b) reduces the PUC of the CanHoldco shares to the level of the PUC of Canco immediately prior to the disposition of the shares.

Where U.K. Co. takes back both non-share consideration in CanHoldco there may be both a reduction in the PUC of the shares of CanHoldco and a deemed dividend. The amount of the deemed dividend will be the excess of the value of the non-share consideration over the PUC of the Canco shares. The reduction in the PUC of CanHoldco will be the excess of the PUC of such shares over the aggregate of the PUC of the Canco shares and the value of the non-share consideration.

Where the PUC of the CanHoldco shares is reduced by Sec. 212.1, the newly-established level of the PUC will be maintained even where U.K. Co. disposes of the shares in a later transaction to another corporation.

Several other provisions of the ITA also result in similar reductions in PUC in a variety of other circumstances. Consequently, prospective investors should ensure that they ascertain and receive indemnities in respect of the PUC for tax purposes of shares of target companies.

Where CanHoldco reduces the legal PUC of its shares and this results in a deemed dividend (Subsecs. 84(3), 84(4) or 84(4.1)), the PUC reduction on the shares held by U.K. Co. is reinvested to the extent of the lesser of the deemed dividend and the reduction which resulted from the application of Sec. 212.1.

D. Acquisition of Canco by a Canadian holding company

To provide the opportunity for asset repatriation up to the equity provided by U.K. Co., an acquisition can be structured as follows:
1. U.K. Co. incorporates a Canadian corporation ("CanHoldco");
2. U.K. Co. capitalizes (PUC) CanHoldco with the acquisition funds;
3. Canholdco acquires Canco.

To the extent available funds and surplus can support it, tax-free dividends can be paid from Canco to CanHoldco and repatriated on a tax-free basis to U.K. Co. with a legal reduction of PUC of CanHoldco.

Sec. 212.1 would not apply in this instance since the PUC of CanHoldco was created by a direct investment by U.K. Co. *prior* to the acquisition of Canco.

E. Indirect acquisition of Canco

Where Canco is a subsidiary of a foreign parent (United Kingdom or otherwise), the acquisition of the foreign parent will result in an indirect acquisition of control of Canco.

In terms of the surplus repatriation issue, it is more difficult to create high PUC where a foreign parent of Canco is the target. To create PUC in Canada equal to the value of Canco at the time of acquisition, Canco would have to be acquired by CanHoldco before the acquisition of the foreign parent. A transfer of Canco to Canholdco after the acquisition of the foreign parent would be subject to Sec. 212.1.

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Where, for example, U.K. Co. wants to acquire U.S. Co. (the parent of Canco), consideration might be given to carrying out the acquisition in the following way:

U.K. Co. incorporates CanHoldco and capitalizes it such that the PUC equals the purchase price attributable to Canco. CanHoldco acquires Canco *prior to* U.K. Co. acquiring U.S. Co. Since immediately prior to the acquisition of Canco, Canholdco technically deals at arm's length with U.S. Co., Sec. 212.1 does not apply even though U.K. Co. may already have an option or agreement to purchase the shares of U.S. Co. prior to the acquisition.

After the acquisition of Canco by CanHoldco, Canco can distribute retained earnings as well as future dividends to CanHoldco. CanHoldco deducts those dividends from its taxable income under Sec. 112. Since CanHoldco has a high PUC it can distribute assets to U.K. Co. free of non-resident withholding tax on a PUC reduction.

A restructuring to establish Canco as a direct subsidiary of U.K. Co. would also avoid the double imposition of withholding taxes (both Canadian and United States) on future repatriations of Canadian earnings to the United Kingdom. A future disposition of CanHoldco by U.K. Co. would not have any adverse tax consequences where U.K. Co. disposes of CanHoldco in a non-arm's length transaction in return for consideration which equals the PUC of CanHoldco.

To the extent that U.S. Co. incurs a tax liability on the transfer of Canco to CanHoldco, such liability would likely represent an absolute cost to U.K. Co. A careful cost/benefit analysis should be undertaken. Consideration might also be given to a possible spin-off of Canco to the shareholders of U.S. Co. in a non-recognition transaction prior to the acquisition. Such shares could then be sold by the U.S. shareholders directly to CanHoldco.

WARNING: This structuring may offend certain Canadian anti-avoidance rules, particularly new Subsec. 245(2), the general anti-avoidance provision ("GAAR").

F. Financing the acquisition

Frequently it is desirable to finance the acquisition of Canco in part with borrowed funds provided either by independent financial institutions or on an inter-company loan from the U.K. parent company. In the case of third-party debt, it will often be desirable to offset interest and other financing costs in respect of the borrowing against Canco's earnings for Canadian tax purposes. To accomplish this, the first step would be the formation of CanHoldco as the acquisition vehicle with CanHoldco borrowing the required funds.

Inter-company borrowing from the U.K. parent might also be used to fund the acquisition of Canco. In this case, CanHoldco would borrow the desired funds from the U.K. company at reasonable market rates or interest. Subject to the thin-capitalization restrictions, CanHoldco would be eligible to deduct the interest and other financing expenses against its income for Canadian tax purposes. A significant tax rate advantage might be gained through inter-company financing. For example, to the extent that interest expense reduces Canadian income otherwise subject to tax at the usual corporate rate of about 45%, the corresponding interest income of the U.K. company would be taxable generally at a rate of only 35%.

Canadian non-resident withholding tax at the rate of 10% would be applied to the interest payments but such withholding tax would be eligible for foreign tax credit relief in the United Kingdom.

G. Merging CanHoldco and Canco

After the acquisition takes place, it is unlikely that CanHoldco would generate sufficient taxable income to absorb the interest and financing costs on the acquisition debt. There are no provisions in the Canadian tax law which permit consolidated returns nor is there any form of group loss relief. Consequently, additional steps will frequently be required to match the acquisition debt with the income stream generated from the Canadian business operation. The traditional solution would be for CanHoldco and Canco to enter into a statutory amalgamation (Sec. 87) or for Canco to be liquidated into CanHoldco (Subsec. 88(1)). Both the amalgamation and liquidation can generally be carried out on a tax-deferred basis. Interest on the acquisition debt should continue to be deductible after the amalgamation or liquidation to offset the earnings of the Canadian business.

For accounting purposes, one of the results of the winding up or amalgamation is the elimination of the investment account on the books of CanHoldco by application against the pre-acquisition retained earnings of Canco and the creation of goodwill on the books of the merged entity to the extent the purchase price exceeds the value of the hard assets of Canco. The goodwill so created is not amortizable for tax purposes. It also does not qualify for the investment allowance for the purpose of the provincial capital tax calculation. Consequently, the provincial capital tax costs of the merged entity will likely be significantly greater than the combined capital tax costs of the separate companies.

To avoid the loss of recognition of the underlying Canadian tax on the accumulated earnings of Canco for U.K. foreign tax credit purposes, such earnings should be distributed as a dividend by Canco to CanHoldco prior to an amalgamation or liquidation. Or it may be possible to leave the holding company structure in place after the acquisition (also avoiding the additional capital taxes). CanHoldco might charge reasonable management fees to Canco in order to generate taxable income to offset financing costs.

Canco could also borrow sufficient funds to pay a

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dividend equal to the amount of its retained earnings to CanHoldco which would use such funds to pay down its acquisition debt. Interest on funds borrowed to pay such a dividend are generally deductible to Canco. The use of CanHoldco with high PUC as the acquisition vehicle will maximize the equity base for purposes of the thin capitalization restrictions.

H. The NRO alternative

Non-residents investing in Canada may wish to use a "non-resident owned investment corporation" (NRO) as part of the financing structure. An NRO is a Canadian incorporated company which complies with certain criteria (outlined below), and elects to be taxed at a flat rate of 25% on all of its income excluding certain capital gains. This 25% tax is refunded when dividends are paid and the applicable non-resident withholding tax is levied on such dividend payments.

To qualify as an NRO, the corporation must meet the following criteria (Sec. 133):

- all of the shares and funded indebtedness must be owned by non-residents of Canada;
- income must be derived from investments, such as securities, mortgages and loans;
- not more than 10% of the income can be derived from rents; and
- the principal business of the corporation must not be the making of loans or the trading in securities.

Because of its lower tax rate and the refundable nature of the taxes paid by an NRO, such companies are frequently used as part of the financing structure where non-resident investors are acquiring Canadian companies. For example, the acquisition of Canco by U.K. Co. using an NRO might be structured as follows:

- U.K. Co. incorporates CanHoldco and contributes the funds necessary for the purchase of Canco in the form of interest-bearing debt and equity in such proportions as not to offend the thin capitalization restrictions.
- CanHoldco acquires the shares of Canco.
- U.K. Co. incorporates NRO and transfers the shares and debt of CanHoldco to NRO in exchange for shares of NRO.

In the past, the same result could have been achieved by causing NRO to make the acquisition of Canco and subsequently transferring the shares of Canco to CanHoldco in partial consideration for debt. However, this may no longer be possible because Sec. 212.1 has recently been expanded to apply to a transfer by an NRO in such circumstances.

In establishing the NRO structure, it is important that the NRO not actually make any loan. Should the NRO make a loan, there is a risk that its qualification as an NRO could be challenged on the grounds that its principal business was the making of loans. The acquisition of the CanHoldco debt by NRO should not be considered to be the making of a loan but rather the purchase of an investment security.

Interest on the inter-company debt owing by Canco to NRO results in tax relief to Canco at the rate of about 45%. The corresponding interest income is taxed at the rate of 25% in the NRO. This tax paid by the NRO is refunded to it when the interest income is in turn distributed to U.K. Co. as a dividend. The ordinary 10% withholding tax applies to the dividend paid by NRO to U.K. Co.

The deductibility of interest to Canco in respect of debt held by the NRO is subject to the same thin-capitalization restrictions as if the debt were held by U.K. Co.

Since both the deduction to Canco and the income inclusion to NRO are recognized on an accrual basis for tax purposes, there is no need to pay the interest to the NRO until cash is required for the payment of taxes, repatriation or reinvestment elsewhere. (A special election (Sec. 78) may eventually be required should the amount of interest remain unpaid at the end of the second taxation year following that in which it was incurred.) Not paying the interest to the NRO avoids having to reloan the interest revenues to CanHoldco which could cause the NRO to be engaged in the principal business of making loans and result in the disqualification of the NRO.

To the extent that the interest is not paid on a regular basis, the debt security should provide for the compounding of interest. In this regard, it should be noted that compound interest is deductible for income tax purposes only at the time it is paid (para. 20(1)(d)). Consequently, provision should be made for the payment of the compound element of the interest to satisfy cash requirements of the NRO in respect of its taxes, expenses and dividends.

I. "Mixing" underlying tax on distributions to the United Kingdom

A company resident in the United Kingdom is able to claim a foreign tax credit in respect of distributed dividends. The credit is calculated for each source of income separately. The amount of the dividend is grossed up to include the underlying foreign taxes which have been levied on the distributed earnings. This includes both the income or corporation taxes imposed by the foreign jurisdiction as well as the non-resident withholding tax. When a foreign company receives dividends from a third jurisdiction, the underlying taxes of the third jurisdiction will also be taken into account. This also applies to the underlying foreign taxes of an eventual fourth jurisdiction in the corporate chain, etc. The tax credit allows for a deduction of the underlying foreign taxes up to the amount of the U.K. corporation tax chargeable on the dividends. The excess of foreign taxes over the U.K. tax liability cannot be carried forward or carried back, but may be taken as a deduction in calculating taxable income for U.K. tax purposes. Because of the separate source rules, the ability to "mix" earnings repatriated from Canada to the United Kingdom is important.

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Where, for example, U.K. Co. directly controls CanHoldco and indirectly Canco, distribution of dividends by CanHoldco to U.K. Co. can result in an excess of underlying foreign taxes (the Canadian income and non-resident withholding tax imposed on CanHoldco may exceed 50%) over the U.K. tax liability on the dividend. On the other hand, upon distribution of dividends from income of NRO to U.K. Co., the underlying foreign taxes will be insufficient to reduce the U.K. tax liability since the NRO tax is a refundable tax and only the withholding tax will be eligible for credit. Under the optimum solution the high foreign underlying taxes of CanHoldco and Canco will be mixed with the low foreign underlying taxes of the NRO to produce a mix which is sufficient to exactly offset the U.K. tax liability.

A variation of the NRO structure described above is to establish CanHoldco and NRO as "sister" Canadian subsidiaries. One advantage of this structure is to permit U.K. Co. to claim exemption under the Canada/U.K. tax treaty in respect of any gain arising on a future sale of the shares of CanHoldco. A disadvantage of the "sister" subsidiary structure is that the potential benefits of mixing high tax and low tax income would be lost.

Another possible variation of the NRO structure is to establish CanHoldco and NRO as sister subsidiaries but to have the shares of each of those corporations held by a holding company located, for example, in the Netherlands. This BV structure is particularly useful in mixing international income flows from various jurisdictions with both high tax and low tax income generated from Canada.

NRO can incur a 10% non-resident withholding tax on dividends to the BV (Art. 10(2)(b) of the 1986 Netherlands–Canada Tax Convention). The dividends received by the BV are exempt from Dutch corporate taxation provided the interest of the BV in the NRO and CanHoldco qualifies for the participation exemption. The dividend distribution by BV to U.K. Co. will be subject to a 5% withholding tax in the Netherlands (Art. 10(2) Netherlands–United Kingdom Tax Convention (1980)). This structure therefore increases the overall withholding tax cost of repatriating Canadian earnings from 10% to 15%.

APPENDIX A

Tax implications of investing in Canada through a branch or subsidiary company.

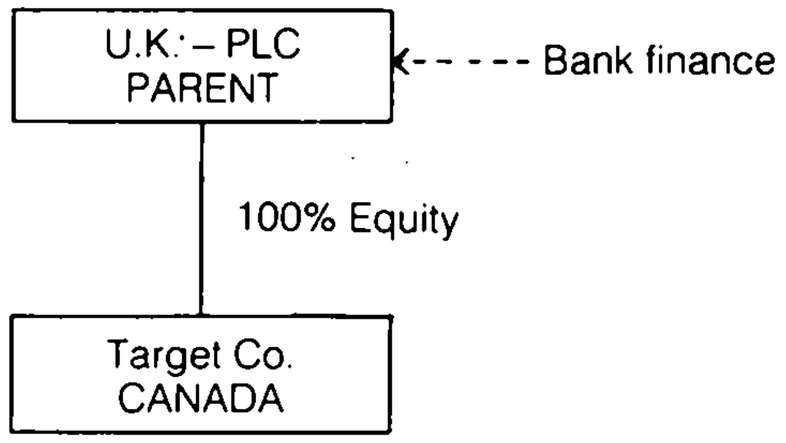
	Branch	*Subsidiary*
Taxable income	1,000	1,000
Corporate tax (44.34%)[1] (federal and provincial combined)	443	443
Net income	557	557
Dividend withholding tax	–	55.70
Branch tax	55.70	–
Total Canadian taxes	498.70	498.70
Remitted to the U.K.	501.30	501.30
Taxable income (U.K.)	1,000	1,000
U.K. corporation tax	350	350
Foreign tax credit	(350)[2]	(350)[2]
U.K. taxes payable	nil	nil
Total of taxes paid	498.70	498.70
Net income after taxes	501.30	501.30

1. No small business or manufacturing and processing deduction.
2. The excess of Canadian taxes over the U.K. tax liability is lost; however, see the comments on "mixing".

APPENDIX B

FINANCING
STRUCTURING OPTIONS

Option I



- Tax relief for interest in the United Kingdom 35%
- Effective corporate tax on Canadian earnings 38%-44%
- Canadian withholding tax on dividends 10%
- Effective Canadian tax cost on repatriated earnings 44%-50%

After tax cost of financing

Nominal rate	10.0 %
U.K. tax relief	(3.5)%
After tax cost	6.5 %

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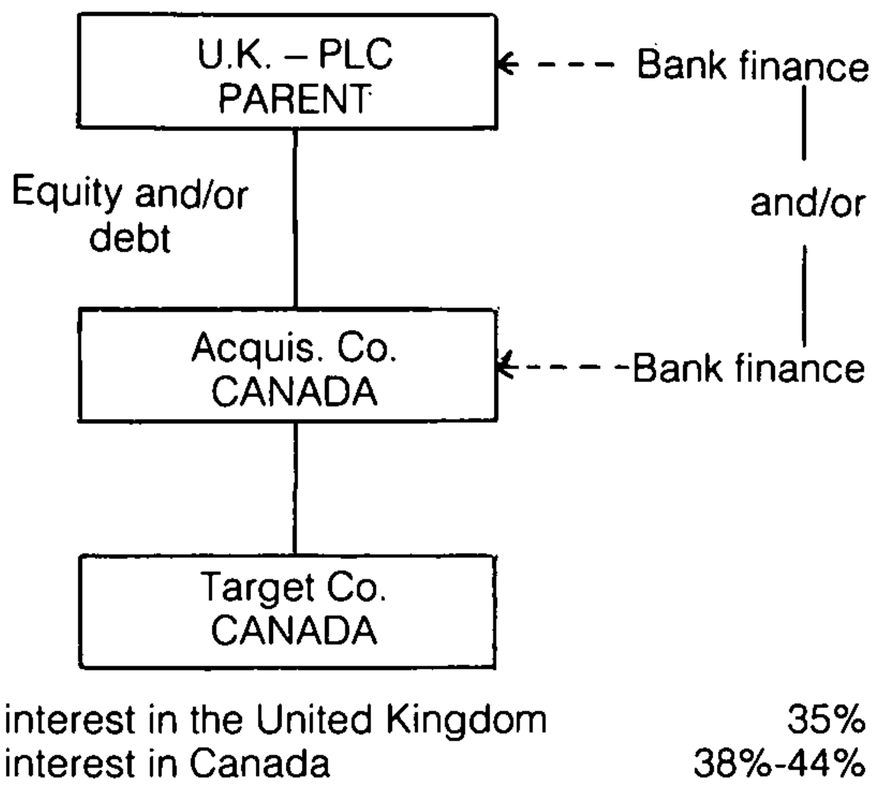
Option II



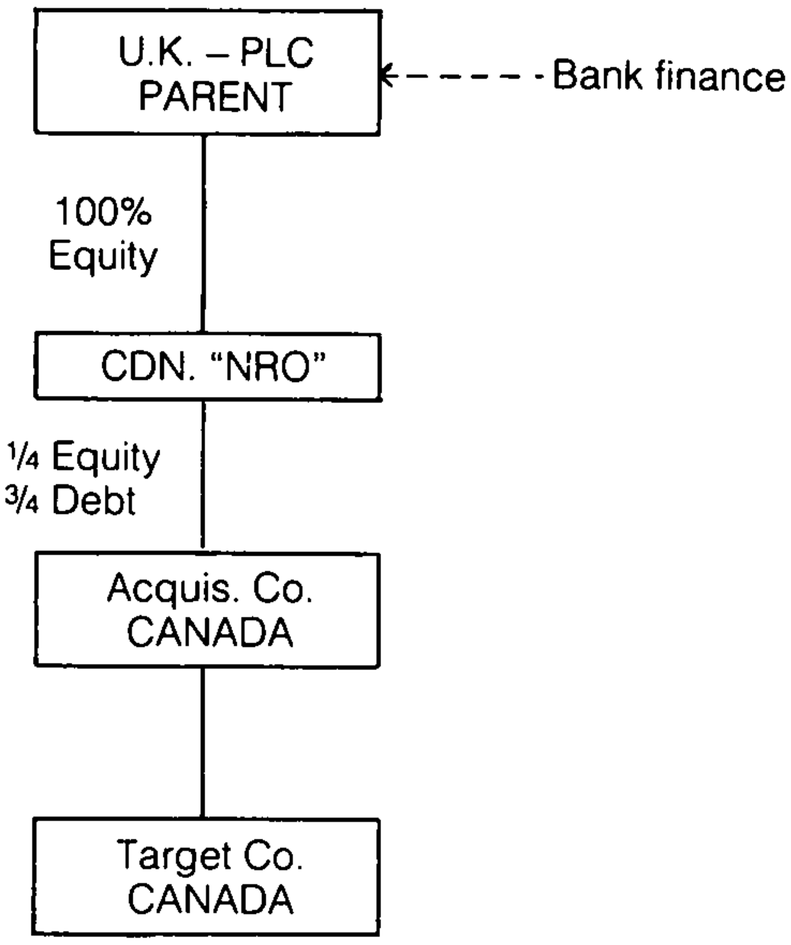
- Tax relief for interest in the United Kingdom 35%
- Tax relief for interest in Canada 38%-44%
- Canadian withholding tax on:
  dividends 10%
  interest to related company 10%
  interest to third party (term > 5 years) 0%
- Interest payable by Target on loans from parent deductible in Canada provided ratio of related party debt to equity does not exceed 3/1.

After tax cost of Canadian financing

Nominal rate	10.0%
Canadian corporation tax relief	(3.8)
Current cost	6.2
Future reduction in withholding tax	(0.6)
Net cost on repatriation	5.6%

(assuming that reduction in Canadian tax does not increase U.K. tax cost on repatriated earnings)

Option III



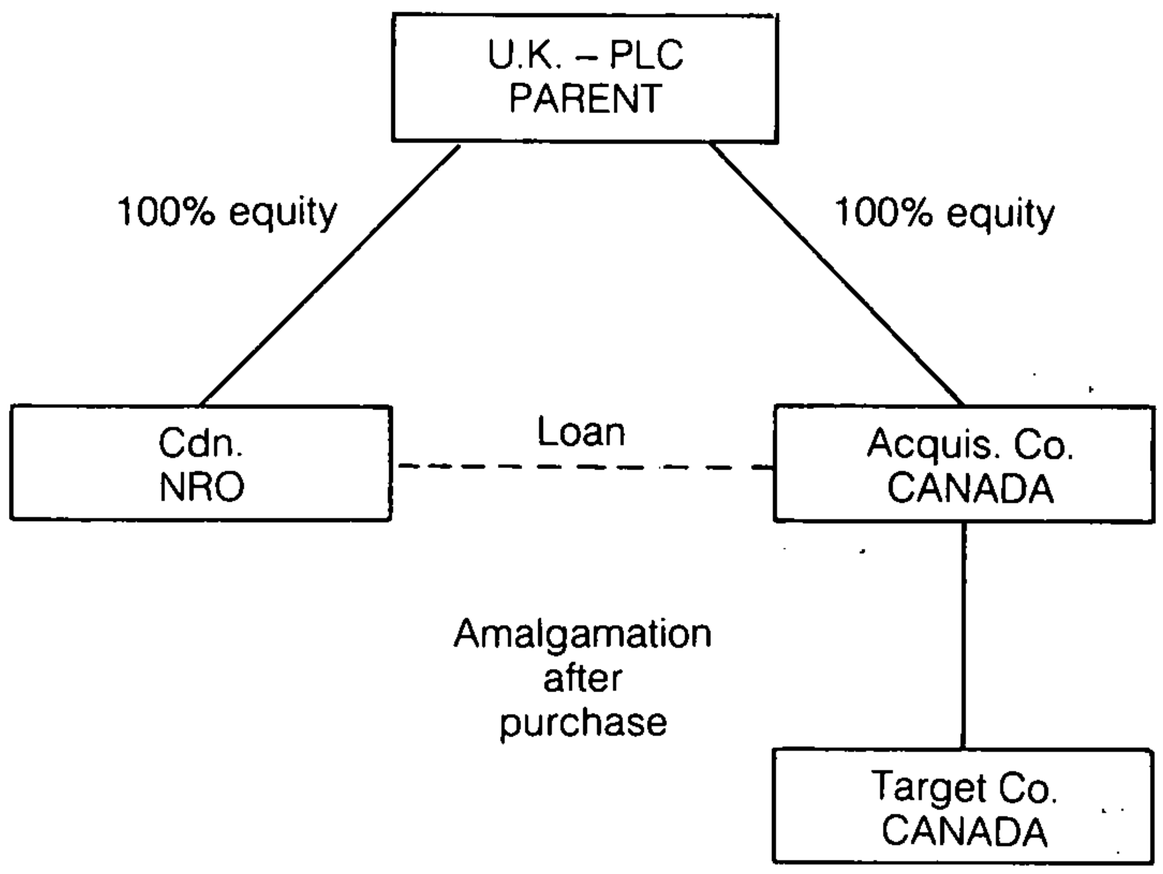
- Tax relief for interest in the United Kingdom 35%
- Tax relief for interest in Canada 38%
- Canadian tax on interest and dividends received by NRO 25%
  (fully refundable when dividends paid to PLC)
- Canadian withholding tax on dividends 10%
- Interest payable by Target to NRO deductible provided ratio of related party debt to equity does not exceed 3/1.

After tax cost of financing

Nominal rate		10.0 %
U.K. tax relief		(3.5)
Net Canadian relief		
– Canadian corporate tax	(3.8)%	
– NRO tax	2.5 %	(1.3)
		5.2 %
Future tax saving on repatriation		
– NRO refund	(2.5)	
– Canadian withholding tax	1.0	(1.5)
Net cost on repatriation		3.7 %

(assuming that reduction in Canadian tax does not increase U.K. tax cost on repatriated earnings)

Option IV



- Tax relief for interest in the United Kingdom 35%
- Tax relief for interest in Canada 38%
- Canadian tax on interest and dividends received by NRO 25%
  (fully refundable when dividends paid to PLC)
- Canadian withholding tax on dividends 10%
- Interest payable by Target to NRO deductible provided ratio of related party debt to equity does not exceed 3/1.

After tax cost of financing

Nominal rate		10.0%
U.K. tax relief		(3.5)
Net Canadian relief		
– Canadian corporate tax	(3.8)%	
– NRO tax	2.5 %	(1.3)
		5.2%
Future tax saving on repatriation		
– NRO refund	(2.5)	
– Canadian withholding tax	1.0	(1.5)
Net cost on repatriation		3.7%

(assuming that reduction in Canadian tax does not increase U.K. tax cost on repatriated earnings)

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The Canada–United Kingdom Income Tax Convention

Interpretation Issues, Recent Developments and Planning Considerations

J. Scott Wilkie*

INTRODUCTION

The purpose of this presentation is to canvass briefly a selection of Canadian tax issues of significance to the application of the Canada–United Kingdom Income Tax Convention (1978), as amended (the "Convention"), taking into account particularly certain changes effected by the Second Protocol to the Convention. It is expected that other commentators will address principal aspects of Canadian domestic tax legislation (apart from the Convention) applicable to investments and other activities in Canada by residents of the United Kingdom. In many cases, indeed, it is the application of such legislation, notwithstanding or apart from the Convention, that is of principal planning importance before considering the effects of the Convention. In the outline following are the principal matters to be discussed at this presentation.

BACKGROUND

The Convention is modelled substantially upon the provisions of the 1977 OECD (Organisation for Economic Co-operation and Development) Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital. The resolution of possible instances of double taxation anticipated by the Convention is not as complete as it could be, particularly when compared with other tax conventions to which Canada is a party. Also, and noteworthy for the purposes of this presentation, Canada has enacted domestic legislation with the intended effect of ensuring that the interpretation of international tax conventions to which it is a party is ambulatory in important respects.

INTERPRETATION ISSUES

Limitations on scope of application

The only Canadian taxes covered are federal income taxes. This limitation can, in certain cases, be material, for example to the taxation of business profits (Art. 7 of the Convention), as a result of inconsistent definitions of "permanent establishment" in the Convention (Art. 5 of the Convention) which affects the ultimate incidence of Canadian federal income tax, and in income tax legislation of the Provinces of Canada. However, in some instances provincial income tax legislation applicable to the income of non-residents specifically conforms to the application of Canada's international tax conventions in certain respects (the Corporations Tax Act of the Province of Ontario will be discussed for comparative purposes).

Income Tax Conventions Interpretation Act

With general effect from 1983, Canada has enacted domestic legislation (Income Tax Conventions Interpretation Act) intended to determine for Canadian federal income tax purposes the manner of the application of important aspects of Canada's international tax conventions. This Act was a direct response to the Supreme Court of Canada's determination in *The Queen v. Melford Developments Inc.*[1] that a treaty article similar to Art. 3(2) of the 1977 OECD Model Convention was to be accorded a static rather than an ambulatory application. Although an examination of the principles of treaty (and, particularly, tax treaty) interpretation in the context of this Act is beyond the scope of this presentation, some attention is devoted to this Act because advisors involved in transactions to which the Convention and other tax conventions to which Canada is a party are relevant should be aware of its existence and its basic thrust. The principal aspects of this Act are:

Undefined terms:
Terms in any international tax convention to which Canada is party not defined, not fully defined or defined by reference to the laws of Canada have the same meanings that they have *for purposes of* (not as defined in) the Canadian Income Tax Act *as amended from time to time,* unless the context in the relevant convention requires a different meaning (see Art. 3(2) of the Convention).

"Permanent establishments":
Except where an international tax convention provides otherwise, profits allocable to a permanent establish-

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1. (1982) *Canadian Tax Cases* ("C.T.C.") 330; 82 *Dominion Tax Cases* ("D.T.C.") 6281.

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ment are determined according to the Canadian Income Tax Act on the same basis as would be required for a Canadian resident carrying on the same activity in Canada. Similarly, *except where an agreement between competent authorities provides otherwise,* the deductibility of amounts in computing such profits is to be determined by the requirements of the Canadian Income Tax Act on the same basis as would be required for a Canadian resident carrying on the same activity in Canada (see, principally, Arts. 5, 7, 9 and 22 of the Convention).

"Canada":
Included are areas beyond the territorial seas of Canada in respect of which Canada may exercise jurisdiction with respect to the seabed and subsoil and their natural resources, and also the seas and airspace above every such area.

"Immovable property"/"Real property":
Included is any right to explore for or exploit mineral deposits and sources in Canada (note the definition of "Canada" referred to above) and other natural resources in Canada, and also rights to amounts computed by reference to the production (including profit) from, or to the value of production from, mineral deposits and sources in Canada and other natural resources in Canada (compare and contrast Arts. 6, 12 and 13 of the Convention).

"Interest":
Prospectively (subject to Sec. 3 of this Act and therefore particular provisions of international tax conventions to which Canada is a party), included will be "deemed interest" amounts as provided in the Canadian Income Tax Act.

In evaluating the potential impact of the Income Tax Conventions Interpretation Act, principal points to consider are:

(a) Unlike Art. 3(2) of the 1977 OECD Model Convention, there is no anticipation that Canada might be required to recognize the meanings of terms, undefined in an international tax convention, according to the laws of another jurisdiction.
(b) It is unclear if there remains any basis for the operation of a mutual agreement procedure provided in an international tax convention in defining otherwise undefined convention terms. It is interesting to consider, in this respect, the difference between Art. 3(2) of the Convention and Art. 3(2) of the Canada–United States Income Tax Convention (1980) which contains explicit recognition of the possibility that internal law definitions may be overriden by mutual agreement resolution (consider Art. 23 of the Convention).

FISCAL DOMICILE (Art. 4)

The Convention contains no objective residence "tie-breaker" rules for persons other than individuals (see Art. 4(3) of the Convention). General principles respecting corporate residence for purposes of the Canadian Income Tax Act are addressed in Volume LXXIIa of the IFA Cahiers. In addition to particular deeming rules applied to determine corporate residence, it is noteworthy that the Canadian Income Tax Act now provides what in part is an anti-avoidance rule which deems a corporation otherwise resident in Canada not to be resident in Canada if it would be exempt from Canadian tax on income derived from sources outside Canada by reason of an international tax convention to which Canada is a party (Subsec. 250(5) of the Canadian Income Tax Act). This, for example, preserves Canada's ability to tax certain kinds of income paid or credited to such a corporation on the basis of the non-resident withholding tax rules contained in the Canadian Income Tax Act, and may, as a result, cause provisions of the Convention to be material where this might not otherwise be the case. This rule ought to be considered, for example, in any situation, whether planned or otherwise, involving dual corporate residence.

BUSINESS PROFITS (Arts. 5, 7, 9 and 12)

Possible anomalies arising from circumstances in which a "permanent establishment" may not exist under the Canadian Income Tax Act and the Convention, but may exist under Canadian provincial income tax legislation are noted above.

Generally, Canadian branch profits are determined according to rules in the Canadian Income Tax Act. Although the principles apparently underlying Art. 7(3) of the Convention and para. 4(b) of the Income Tax Conventions Interpretation Act appear to be similar, it is not entirely clear that this is the case for the principles of profit determination in Art. 7(2) of the Convention and para. 4(a) of such Act.

The clearest example of the confinement of deductibility of "expenses" presented by Art. 7(3) of the Convention and the Income Tax Conventions Interpretation Act arises with respect to Crown royalties payable in respect of natural resource activities in Canada. These are not deductible in computing income under the Canadian Income Tax Act; a non-resident paying such amounts would not be able to deduct such royalties in computing profits allocable to a Canadian permanent establishment under Art. 7 of the Convention. Consider, for example, whether there are possible negative indirect effects on eligibility for foreign tax credit in the United Kingdom.

Canada recently has formalized, as a matter of administrative practice and policy, transfer pricing principles to be applied in respect of transactions between related parties.[2] In light of such statements of practice and policy, Arts. 7(2), 7(3), 7(4), 9, 21(4) and 22 of the Convention and the Income Tax Conventions In-

2. See Revenue Canada, Taxation Information Circular 87-2, which has application to services transactions and the allocation of general and administrative expenses among components of business enterprise, as well as to transactions in goods and research and development costs.

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terpretation Act, allocation issues may be expected to attract greater attention in Canada. Consider also recently proposed changes to the Canadian Income Tax Act as part of Canadian "tax reform" which modify the circumstances in which certain expenses (for example, real property development costs) are deductible in computing income, as well as proposed changes to such Act with respect to the deductibility in computing income of interest on borrowed money. Consider also increasing attention devoted by Canadian courts to the relevance of generally accepted accounting principles in the computation of profit for tax purposes.

Apposite, in particular, to a consideration of the possible implication of the application of Canadian income computation and deductibility rules (and transfer pricing rules) to the determination of profit for purposes of Art. 7 of the Convention, taking into account Art. 9 of the Convention, is the introduction into the Convention of a sourcing rule contained in an amendment to Art. 21 of the Convention effected by the Second Protocol to the Convention. Art. 21(4) applies in circumstances where profits of an enterprise of one Contracting State are taxable in that State and also are included in the profits of another person resident in the other Contracting State and not dealing at arm's length with the enterprise in the first State. In such a case, if the profits would have been those of the enterprise in the second State if the enterprises had been dealing with each other completely independently of each other, they are treated as profits of the enterprise in the first State from a source in the second State. Relief from double taxation is to be achieved through other provisions of Art. 21 (foreign tax credit, foreign affiliate and underlying tax credit rules: Art. 21(1) and (2)). Art. 21(4) is partial relief from the absence in Art. 9 of any requirement for compensatory adjustments to the profit of the enterprise in the first State arising from the application of such Art. 9.

It may be problematic in certain instances whether fees are paid by Canadian residents for information, in which case Art. 12 may operate to preserve Canada's taxing jurisdiction, or for services, in which case, presumably, the provisions of Art. 7 ought generally to be applicable.

BRANCH TAXATION (Art. 22(3) and (4))

The comments above concerning business profits and, in particular, those directed to the application of the Canadian Income Tax Act in determining the deductibility of amounts in computing income and to Canadian transfer pricing principles, are relevant here.

Careful attention must be paid to the ultimate structure desired for Canadian business operations and the operation of "branch tax" rules in the Canadian Income Tax Act (perhaps in an interim period). Although a Canadian branch may later be incorporated, usually this determination should be made before significant profits arise (and should have been considered at the outset of commencing activities in Canada); however, the intended operation as a branch only to secure the branch tax profit exemption may give rise to concerns about whether the branch ever had a reasonable expectation of profit and accordingly whether it reflected a business carried on in Canada by the non-resident. (However, whether the Canadian revenue authorities would pursue this line of offence, for example, to deny the deductibility in computing income of certain amounts, is problematic if the non-resident would not be taxable in Canada in respect of the relevant income if it was not carrying on business in Canada.) Whether Canadian "tax deferral" "roll-over" rules would provide adequate protection against the exigibility of Canadian tax upon incorporation should be considered. Commencing Canadian activities using a Canadian corporation to own assets expected to appreciate in value, which would enter into lease or licence arrangements with the branch, might be considered. Ultimately, the branch operations might be assumed by or be transferred to the Canadian corporation. However, in the interim the Canadian corporation would generally be expected to earn some amount of taxable income.

DIVIDENDS (Art. 10)

The Second Protocol to the Convention expands the circumstances in Art. 10 in which a Canadian shareholder of a U.K. corporation may receive credit for the U.K. tax (ACT) paid by such corporation which pays a dividend to such shareholder. Essentially, more Canadian shareholders are reflected in the operation of the U.K. imputation system. A change effected by the Second Protocol is to provide partial ACT credit to Canadian corporate shareholders of U.K. corporations that control 10% or more of the voting power of the U.K. corporation: the shareholder is entitled to one-half of the ACT credit and is subject to a maximum rate of United Kingdom tax of 10% on the total of the dividend and the credit. The excess of the credit over the permitted U.K. tax is refundable. The ACT credit may be received free of tax under the Canadian foreign affiliate rules in appropriate circumstances if certain amendments to these rules proposed on 23 December 1985 are enacted, resulting in a net increase to cash flow of Canadian corporations having substantial direct investments in U.K. corporations with active business earnings as determined according to such foreign affiliate rules (see also Art. 27(4) of the Convention).

Although perhaps not of direct relevance to the application of the Convention, as part of Canadian tax reform, dividends paid by Canadian corporations may be subject to corporate distributions taxes at the corporate payor level, intended generally (with certain other rules applicable to Canadian corporations entitled to receive such dividends free of tax) to ensure that dividends are paid only out of taxed earnings on the basis of a combined federal and provincial tax rate of 40%. Such dividends paid to a non-resident of Canada still will be subject to non-resident withholding tax subject to the rate limitations provided in the Convention. U.K. shareholders of Canadian corporations may

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wish to take this into account in devising capital structures of Canadian corporations. Also, in certain cases referred to below, dividends may be treated as interest under the Canadian Income Tax Act.

Subject to "treaty shopping" and anti-avoidance considerations and certain specific rules in the Canadian Income Tax Act, in certain circumstances there may be advantages to extracting the value reflected in a shareholding in a Canadian corporation as dividends rather than as capital gains if such gains might otherwise be taxable by Canada even after taking account of Art. 13 (for example, an incorporated real property investment).

Consider the effects of the contemporaneous operation of Art. 10 and certain rules in the Canadian Income Tax Act which apply to treat dividends as interest in some circumstances. Related issues include effects through the operation of the Canadian foreign affiliate rules and implications for foreign tax credit.

INTEREST (Art. 11)

The only significant change to Art. 11 by reason of the Second Protocol is a reduction in the permitted rate of withholding tax on interest from 15% to 10%. Although this change does not in itself suggest planning opportunities, it is a significant change in the context of Canada's international tax convention arrangements generally, which do not provide zero rates of withholding on payments of interest to non-residents, and, generally, provide that such withholding rate is 15%. Usually attempts are made to ensure that a withholding tax exception under the Canadian Income Tax Act applies to interest paid or credited to non-residents, although this is not always possible (particularly in non-arm's length situations), and in certain circumstances may not be permitted if the interest is a species of participating payments to which the domestic withholding tax exceptions are not extended. In these circumstances, the United Kingdom may be a relatively attractive "lender" jurisdiction, taking into account particularly any limitations on the utility of foreign tax credit in a "lender's" jurisdiction.

Canada's ability to tax interest is preserved by the Convention to the extent that the interest arises in Canada. Subsecs. 212(13) to 212(13.2) of the Canadian Income Tax Act provide that in certain circumstances, including with respect to the payment of interest in certain cases, payments made between non-residents of Canada may nevertheless be subject to Canadian non-resident withholding tax. This result is effected by deeming the payor to be a resident of Canada. However, the Canadian Income Tax Act does not deem such payments to arise in Canada. The Convention deems interest to arise in the Contracting State of which the payor is a resident. In these particular circumstances a "dual corporate resident" issue could arise which under the Convention, unlike other tax conventions to which Canada is a party, can be resolved only with resort to the competent authority procedure. However, the Convention also provides that if the debt on which the interest is payable is connected to a permanent establishment which the payor has in a Contracting State and the interest is *borne by* that permanent establishment, then it is deemed to arise in the Contracting State in which the permanent establishment is situated. In the context of this discussion, the issue then becomes whether, for example, a permanent establishment exists in Canada, and if so whether the interest is a cost borne by that permanent establishment. The meaning of "borne by" has been addressed by the Canadian revenue authorities in other tax convention contexts (the "Dependent personal services" Article of the Canada–United States Income Tax Convention (1980)). It is problematic whether a Canadian permanent establishment will be regarded as bearing the interest cost if through various means, such as administration charges, it bears the equivalent economic burden.

ROYALTIES (Art. 12)

Para. 212(1)(d) of the Canadian Income Tax Act charges certain payments, such as rents and royalties, to withholding tax. If the payments can be regarded as for services rather than for certain information, then the ultimate taxability in Canada of such payments may be determined under the "Business profits" Article of the Convention (Art. 7). However, in many cases this distinction is difficult to establish or defend practically. This is also a planning concern with respect to various "earnout" arrangements, for example as frequently may be provided in management agreements between a United Kingdom parent corporation and its Canadian subsidiary.

CAPITAL GAINS (Art. 13)

An exception to Canada's residual ability under the Convention to tax gains from the disposition of shares deriving their value from immovable property (consider in this connection the Income Tax Conventions Interpretation Act) situated in Canada is provided if such shares are quoted on "an approved stock exchange". Similar rules apply to trusts and partnerships the assets of which are such shares. Some planning latitude may be presented by the reference to "an approved stock exchange". For example, it is not, apparently, a requirement for this exception to operate that the shares of a Canadian corporation be quoted on a stock exchange satisfying the requirements in this regard of the Canadian Income Tax Act and Income Tax Regulations; a similar comment is apposite in respect of shares of a United Kingdom corporation. Depending on the planning circumstances, and subject to "treaty shopping" and anti-avoidance concerns, it might be desirable to list shares of a Canadian corporation on an exchange approved under United Kingdom rules; presumably the converse would be the case with respect to the shares of a United Kingdom corporation, although in most cases greater flexibility may be presented by United Kingdom rules in this regard.

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A separate exception applies with respect to indirect dispositions of immovable property for holders of less substantial (essentially, less than 10%) interests in corporations, trusts and partnerships deriving their value from immovable property. Subject to "treaty shopping" and anti-avoidance concerns, consideration might be given to arranging, in some manner, United Kingdom investments in Canadian real property vehicles to be able to rely on this exception.

A change effected by the Second Protocol of greater significance than might at first blush seem to be the case is the exclusion from the indirect definition of immovable property in Art. 13(5) of the Convention of the premises on or at which an enterprise conducts its business. This issue has arisen in the context of the Canada–United States Income Tax Convention (1980), which does not provide equivalent relief or clarification. In this circumstance, the Canadian revenue authorities have suggested that the shares of, for example, a Canadian manufacturing corporation which conducts its business from premises located on valuable land may, subject to a balance sheet valuation analysis, derive their value substantially from real property (immovable property) situated in Canada even if it is not in a real property-related business. It is understood that this may, in these circumstances, be relevant to obtaining appropriate clearances under Sec. 116 of the Canadian Income Tax Act for dispositions of shares of Canadian corporations and to the ultimate taxability in Canada of dispositions of such shares.

Subject to many other considerations with respect to the determination of total tax burdens, it may be advisable to consider indirect rather than direct Canadian real or resource property investments and acquisitions in order to take advantage of provisions of the Convention which protect against Canadian taxation of indirect interests in immovable property.

Art. 27(2) ought not to be overlooked in any determination of whether Art. 13 applies to an alienation by a resident of the United Kingdom of "taxable Canadian property". This rule may be of ambiguous interpretation in the context of the Canadian application of the Convention. For Canadian tax purposes, capital gains, or gains, are a species of income, taxable as such under the Canadian Income Tax Act. Yet, the Convention uses the terms income and gains in apparent contradistinction. The question is the appropriate treatment under the Canadian Income Tax Act and the Convention of an unremitted gain realized by a resident of the United Kingdom upon an alienation of "taxable Canadian property", taking into account the use of the terms income and gains in the Convention and the genesis of Art. 27(2) (understood to be directed entirely at circumstances of United Kingdom taxation and to be intended to ensure that conventional income amounts from a United Kingdom perspective do not benefit from Convention relief if not subject to the United Kingdom tax regime). In this context the Income Tax Conventions Interpretation Act may be relevant.

Canada may only tax capital gains arising from dispositions of "taxable Canadian property". It is noted that the "taxable Canadian property" status of shares of Canadian corporations may be preserved notwithstanding the occurrence of certain Canadian tax-deferred reorganizations. This would be of significance, for example, where a United Kingdom shareholder disposed of shares of a private Canadian corporation in exchange for shares of a public Canadian corporation. Shares of a public Canadian corporation otherwise only are "taxable Canadian property" if the shareholder has or had a substantial shareholding as described in the Canadian Income Tax Act. However, if a "taxable Canadian property" characterization preservation rule has applied to the exchange, the shares of the public Canadian corporation still may be "taxable Canadian property".

It is noted that the Convention does not provide the same kind of mutual reorganization relief as is presented, for example, in the Canada–United States Income Tax Convention (1980).

FOREIGN TAX CREDIT (Art. 21)

In discussion, the implications of the decisions in *The Queen v. the Bank of Nova Scotia*[3] and *Canadian Imperial Bank of Commerce v. The Queen*[4] will be considered particularly for their effect on the manner in which foreign currency fluctuations ought to be taken into account in calculating Canadian foreign tax credit, and also for their guidance on the principles to be applied in interpreting the Canadian Income Tax Act in the context of provisions of a tax convention to which Canada is a party.

COMPETENT AUTHORITY PROCEDURES (Art. 23)

The Canadian competent authority, the Minister of National Revenue and his authorized representative, is involved in programmes and practices with respect to both civil and criminal tax matters.

The Canadian competent authority participates in various exchanges of information: automatic exchanges, spontaneous exchanges, specific requests for information, simultaneous examination programmes (civil and criminal), industry studies programmes and Government exchanges.

The Canadian competent authority will become involved in resolving both juridical (because of the application of the law according to its terms beyond the control of the taxpayer or because of the way in which the taxpayer has situated itself within the Canadian tax system) and economic (for example arising from the need for compensating discretionary adjustments to income taking into account the application of the laws of another jurisdiction) double taxation.

3. (1981) C.T.C. 162; 81 D.T.C. 5155 (FCA).
4. 81 D.T.C. 5199 (FCA).

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Competent authority procedures are commenced in Canada upon the request of a taxpayer after it has been, or in its anticipation of being, refused Canadian adjustments apparently required by reason of the application of foreign laws, or upon an actual or anticipated adjustment of Canadian income resulting or expected to result in double taxation. Once a request for competent authority assistance has been accepted by the Canadian competent authority, the matter is dealt with between the competent authority of Canada and the competent authority of the other jurisdiction without the involvement of the taxpayer unless, and only to the extent that, the taxpayer is requested to provide information or clarification to the Canadian competent authority in respect of the issues under consideration.

The competent authorities themselves negotiate and effect any settlement; the taxpayer will be advised of the settlement, which the taxpayer may accept or reject. There is no procedure to address situations in which a settlement cannot be reached. In this regard, a Canadian taxpayer is well advised to protect the availability of its rights of objection and appeal under the Canadian Income Tax Act, although if the taxpayer chooses to proceed with the appeal process provided in the Canadian Income Tax Act while negotiations between the competent authorities are proceeding, such negotiations will be terminated. If however, a matter is adjudicated by a Canadian court, the result of the decision cannot later be changed by a competent authority proceeding, at least by the Canadian competent authority; any relief from double taxation in that circumstance would have to be as a result of the foreign competent authority's decision. A competent authority settlement rejected by a taxpayer is void.

There may be tax issues which the Canadian competent authority will not pursue.

MISCELLANEOUS PLANNING CONSIDERATIONS

These considerations, which are not intended to be exhaustive, will be addressed more completely in discussion:

- sales of receivables by a Canadian subsidiary to its United Kingdom parent as a way of financing without attracting Canadian non-resident withholding tax in respect of financing costs; the treatment of late financing charges as interest; financing by prepayment of receivables by a United Kingdom parent corporation to its Canadian subsidiary;
- payments of dividends rather than realizations on shares;
- use of a holding corporation to collect dividends from a Canadian operating corporation;
- capitalizing a Canadian corporation to effect the acquisition of shares of another Canadian corporation and generally;
- holding a Canadian investment through a non-resident trust;
- "branch tax" planning and the choice of operating a business in Canada through a branch at a corporation; and
- effecting investments in Canadian real estate, including carrying on business and permanent establishment considerations.

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Recent Developments from a United Kingdom Perspective on the Canada–United Kingdom Tax Convention

Jonathan S. Schwarz*

INTRODUCTION

The present Treaty with Canada of 8 September 1978 replaced the previous Treaty with Canada of 12 September 1966 (Statutory Instrument (SI) 1967 No. 482). Before entry into force, the Treaty was amended by the Protocol of 15 April 1980 (SI 1980 No. 1,528). The Treaty entered into force on 17 December 1980 and the first Protocol entered into force on 18 December 1980. A second Protocol was signed on 16 October 1985 (SI 1985 No. 1996) and entered into force on 23 December 1985.

A. TAXES COVERED

Art. 2 of the Treaty specifies the taxes covered by each country. In the United Kingdom, the Treaty applies to the income tax, the corporation tax, the petroleum revenue tax and the development land tax. Development land tax, however, was abolished in the United Kingdom as regards events occurring after 18 March 1985 by the Finance Act 1985 Sec. 93. There are no identical or substantially similar taxes that have been imposed by the U.K. Government after the date of signature of the Convention.

B. FISCAL DOMICILE

In terms of Sec. 66 of the U.K. Finance Act 1988, companies incorporated in the United Kingdom after 15 March 1988 are deemed resident for tax purposes irrespective of their place of central management and control. Thus the United Kingdom is in a somewhat similar position to Canada in that locally incorporated companies will always be resident for domestic tax purposes. The central management and control test will, however, continue to apply in relation to companies incorporated outside the United Kingdom. It is therefore possible for U.K. purposes that companies incorporated in Canada but managed and controlled from the United Kingdom will be resident in the United Kingdom. Art. 4 of the Convention contains an unusual rule in relation to dual resident companies. Unlike the OECD Model which requires such issues to be resolved by reference to the place of effective management of the company, the Treaty requires the competent authorities to "endeavour" to settle the question by mutual agreement and to determine the mode of application of the Convention to such person. The implications of this rule are twofold:
Firstly, the competent authorities are not obliged to resolve the question of residence but merely should endeavour to do so. In addition, no guidelines are given whatsoever as to how the competent authorities might go about dealing with the issue. Secondly, it would appear that the competent authorities have a free hand as to how the Treaty would be applied.

The new U.K. incorporation test may reduce the likelihood of this happening at least in relation to U.K.-incorporated companies, although the question must remain a difficult one for companies formed under the laws of third countries.

C. PERMANENT ESTABLISHMENT/BUSINESS PROFITS

It is interesting to note that permanent establishment Art. 5 follows the 1963 OECD Model rather than the 1977 Model. Art. 7, which dealt with business profits, is the same in both versions of the OECD Treaty and is followed here.

The difficult task of determining how income should be allocated to a permanent establishment has recently been considered by the Court of Appeal and House of Lords in the case of *Sun Life Assurance Company of Canada Limited v. Pearson* (H.M. Inspector of Taxes).[1] The case is somewhat complex in that a large number of issues are raised both under the 1967 Treaty and the 1980 Treaty. The case raised many interesting issues, but the essential question was the manner of determining the profits of the U.K. branch of Sun Life, a Canadian resident life insurance company. Under domestic U.K. law (Sec. 316 of the 1970 Act), a proportion of the company's investment income wherever received was deemed to be the profits chargeable to tax in the United Kingdom. The chargeable portion corresponded to the ratio of the company's liability to U.K. policyholders to its liability world-wide. In addition (under Secs. 312 and 318 of the 1970 Act), a separate charge was imposed on the company's profits from annuity or pension business. This was based on a similar proportion of the company's world-wide profits from such business. Sun Life

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1. 1984 British Tax Cases (BTC) 223 and 1986 BTC 282.

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appealed certain assessments relying on the provisions of the 1967 and 1980 Treaties on the basis that profits attributed to the permanent establishment should be those which the permanent establishment might have been expected to make if it were an independent establishment. This provided a more favourable basis for the taxpayer.

I do not propose to go through the argument in relation to the 1967 Treaty since the key provisions contained in Art. 6(7) which make specific reference to the rules relating to the taxation of life assurance companies is not found in the current Treaty. Although Art. 7(2) of the current Treaty requires profits to be allocated to a permanent establishment (the profits that might be expected if it were a distinct and separate enterprise dealing in a wholly independent manner), Art. 7(4) states that:

> Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles embodied in this Article.

In the Court of Appeal, Lord Justice Fox felt that it was just as likely as not that Art. 7(4) of the 1980 Treaty was intended to authorize the retention of the existing U.K. domestic regime, bearing in mind that when the Treaty was signed, the specific statutory rules had been in force for 8 years, and the principle of taxing a conventional proportion of investment income earned by life assurance companies in such circumstances had continued for much longer. In construing Art. 7(4), he noted firstly that the Article cannot require a close connection between the method permitted by that Article and the principle laid down in Art. 7(2). He concluded that Art. 7(4) must be authorizing some computation based on an apportionment of total profits. Insofar as such an apportionment is to give effect to the separate enterprise principle, he suggested that it must be crude in its operation to some degree. The real question was whether the U.K. domestic method could fairly be regarded as sufficient to satisfy the principles of Art. 7(2). The apportionment principles imposed under domestic law consisted of the ratio of the average of liabilities for the period to policyholders resident in the United Kingdom over the average of liabilities for that period for all the company's policyholders less the expenses of management attributable to the U.K. branch. That computation he said in practical terms gave reasonable weight to the earnings liabilities and expenses of the branch, and, as a result, gave adequate effect to the principles of Art. 7 generally. A related issue was whether proposals relating the policyholders resident outside the United Kingdom could be said to have been made to the taxpayer "at or through its branch or agency in the U.K." so that the liabilities in respect of those policies should be included in the formula as being U.K. liabilities. In examining the method of dealing with insurance proposals outside the United Kingdom, but effectively dealt with in the United Kingdom, the Court concluded that they should be so included. Although this was not one of the key issues of the case, it suggests a broad application as to what should be attributed to the U.K. branch or permanent establishment.

D. DIVIDENDS

The United Kingdom has an imputation system of corporate taxation whereby qualifying shareholders receiving dividends from the U.K. resident company are entitled to a tax credit in respect of the dividends which may be offset against the shareholders' U.K. income tax liability on the dividends and the excess refunded by the U.K. tax authorities. The tax credit is currently at 25/75 of the dividend.

The United Kingdom does not impose any withholding tax on payments whether to resident or non-resident shareholders. However, on making a dividend payment, the U.K. resident company must account to the Inland Revenue for an advance payment of corporation tax (ACT). Advance corporation tax may be set off against the company's corporation tax liability for the period in which the dividend was paid, periods within the preceding 6 years or any future period. ACT is a prepayment of "mainstream" corporation tax liability and is not a tax on the dividend itself. It is therefore never reduced by the usual dividend provisions of the OECD Model Treaty. Prior to the negotiation of the Second Protocol, no refund of ACT was provided for Canadian residents under the Treaty.

Art. 10 of the Treaty was substituted by the Second Protocol. It divides Canadian resident shareholders receiving dividends from U.K. resident companies into 2 categories:
(i) *Direct investors:* Canadian resident companies owning directly or indirectly alone or together with one or more associated companies 10% or more of the voting power of the U.K. resident company dividend. Such shareholders are entitled to payment to them of one-half of the tax credit which a U.K. resident individual shareholder would have received on the dividend, less a withholding tax of 10% on the dividend plus the one-half tax credit refunded.
(ii) *Portfolio investors:* all other Canadian resident shareholders. Such shareholders are entitled to a payment of the full tax credit equivalent to that which a U.K. resident individual shareholder would have received from the dividend less a withholding tax on 15% of the dividend plus the tax credit.

For the effect of the Treaty on dividends see Table (Dividends: Canada–U.K. Treaty).

The rules relating to dividends have recently been considered in a case decided on 31 August 1988. In *Union Texas International Corporation v. Critchley* (H.M. Inspector of Taxes), the High Court was asked to consider the effect of Art. 10 of the United King-

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Dividends: Canada–U.K. Treaty

	(a) Tax credit refund to "portfolio investors"		(b) Tax credit refund to "direct investors"		(c) No tax credit refund	
	Income £	Tax £	Income £	Tax £	Income £	Tax £
Profit before tax of U.K. company	100.00		100.00		100.00	
Corporation tax at 35%	(35.00)	35.00	(35.00)	35.00	(35.00)	35.00
Dividend to foreign investor	65.00		65.00		65.00	
Tax credit/half tax credit	21.66	21.66	10.83	10.83	—	—
	86.66		75.83			
U.K. income tax on dividend plus credit/ half credit	(15%) (12.99)	12.99	(10%) (7.58)	7.58		
Net receipt by foreign shareholder	73.67		68.25		65.00	
Effective U.K. tax rate dividend		26.33		31.75		35.00

This form of calculation of the refund is in accordance with the *Union Texas* case.

dom–United States Treaty in relation to refunds of ACT. In general terms, the Treaty is similar to the Canadian Treaty in this regard, except that, on direct investment, the rate of withholding is 5% rather than 10%.

The case, which received some notoriety largely as a result of the fact that the Judge took more than 2 years to render his decision, and did so after press publicity on this fact, involved the question as to whether the United Kingdom was entitled to withhold any part of the ACT refund at all. The U.S. parent company, in reclaiming deductions of some £ 23 million, argued that under U.K. domestic law there are no provisions authorizing the deduction of the withholding tax and that the Treaty itself imposes no charge to tax.

In rejecting the appellant's claim, Mr. Justice Harmond considered that it was plain that the intention of the contracting parties in negotiating the Treaty was trying to provide for the system of imputed tax and credits due in respect of dividends under such a system. If the appellant was correct, then the references to the tax credit repaid were not some kind of tax credit otherwise appearing in the U.K. tax system, they would then be an invention of the negotiators of the Treaty, which he found improbable. The relevant words of the treaty were intended by the contracting parties to have some meaning and the Court should try and discover a workable meaning if it can. Precisely the same issues will no doubt arise in relation to all Treaties, including the Canadian Treaty, where a refund of ACT is permitted subject to some withholding of part of the refund.

On a technical level, I am inclined to support the views of the appellant. It seems that a contrary decision may well have been met by legislative action, since it is understood that in relation to the United States alone, claims for repayment of tax withheld would exceed £ 1 billion.

Union Texas did, however, win on an entirely separate and subsidiary point relating to the mechanics of calculating the correct amount. The Treaty was clear as to what was required in this regard, namely to find the aggregate of the amount or value of the dividend and the amount of the tax credit paid to the U.S. shareholders. Once that aggregate was found, the relevant percentage was to be deducted. This was in contrast to the Inland Revenue formula which resulted in excess amounts being withheld.

The treatment of U.K. "foreign affiliates" of Canadian shareholders is one of the more preferential dividend regimes for non-residents. Identical rules are found in the Norway treaty. More favourable treatment is only found in the treaties with the United States, Denmark, Finland, Luxembourg, the Netherlands, Sweden and Switzerland where the one-half tax credit is granted to 10% or more shareholders subject to a lower rate of tax on the dividend plus one-half of the tax credit of only 5%. Other treaties, such as those with Australia and New Zealand, do not grant any credit to companies, and the treaties with Zimbabwe and Trinidad and Tobago impose a 20% tax on the dividend and tax credit while the Philippines treaty provides for a 25% tax.

E. INTEREST

In terms of amendments to Art. 11(2) by the Second Protocol, the rate of withholding tax on interest from U.K. sources paid to Canadian residents is reduced to 10%.

F. THIN CAPITALIZATION

U.K. domestic law Sec. 209 Income and Corporation Taxes Act 1988 includes provisions whereby interest paid by a U.K. company to a non-resident company is treated as a distribution and therefore subject to the ACT rules if the U.K. resident company is a 75% subsidiary of the non-resident company or both are 75% subsidiaries of another company. These rules do not apply where the third company is a U.K. company and 90% or more of the share capital of the paying company is owned by a U.K. resident company.

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Certain other interest payments may similarly be treated as dividends, for example where the interest varies with the profits of the company and is paid at a rate in excess of a reasonable commercial return.

These rules are overridden by Art. 11(9) which requires such rules not to require interest payments to be treated as a distribution. In relation to interest paid by U.K. companies, the treaty protection does not apply where the recipient is a Canadian resident company of which more than 50% of the voting power is controlled directly or indirectly by U.K. residents.

G. CAPITAL GAINS

The Second Protocol substituted new and detailed rules relating to the taxation of capital gains. Under U.K. domestic law, individuals who are not resident or ordinarily resident in the United Kingdom are only subject to tax on capital gains derived from assets situated in the United Kingdom. The new rules only have the following very limited application: first, where the assets relate to a trade carried on through a branch or agency in the United Kingdom; second, where the assets represent exploration or exploitation rights in relation to certain mineral resources within the United Kingdom or U.K. offshore areas, shares (other than those quoted on a recognized stock exchange) deriving the greater part of the value from such exploration or exploitation rights, finally, gains arising from the disposal of interests in land in the United Kingdom again are taxed as income under U.K. anti-avoidance provisions relating to artificial transactions in land.

Generally, disposals of such assets are not protected from taxation in the hands of Canadian residents under the Treaty. Perhaps the only limited protection is in relation to shares of resource companies where the Canadian resident shareholder owns less than 10% of each class of shares in the company. Such shareholders would not be subject to tax in accordance with Art. 13(6) of the treaty.

Looking to the future it may well be that the provisions of Art. 13(9), which were introduced in order to protect Canada's right to departure tax from former residents, may well apply to U.K. companies ceasing to be resident after 15 March 1988.

H. ELIMINATION OF DOUBLE TAXATION

Art. 21(2) provides that credit is to be allowed against United Kingdom tax payable. Tax payable under the laws of Canada and in accordance with the Treaty with respect to profits, income or chargeable gains from sources within Canada is allowed as a credit against any United Kingdom tax computed by reference to those same profits by reference to which the Canadian tax is computed. It should therefore be noted that the credit is only available to income from Canadian sources. Furthermore, in the case of the dividend underlying corporate tax payable in respect of the profits out of which the dividend is paid, is excluded from the credit.

However, in the case of a dividend paid by a company resident in Canada to a company resident in the United Kingdom and which controls directly or indirectly at least 10% of the voting power of the Canadian company, the credit takes into account underlying corporate tax in respect of profits out of which dividends are paid in addition to the direct tax credit.

An important issue arose recently in the case of *Collard v. Mining and Industrial Holdings Ltd.*[2] in connection with the inter-relationship between the foreign tax credit provisions of the treaty and the advance corporation tax credit. In that case, the Revenue argued that the foreign tax credit was only available as a deduction after ACT had been taken into account. ACT then had to be spread ratably across the company's income. The Court, however, held that the company was entitled to make a deduction for the foreign tax credit before it made a set-off for corporation tax in computing the amount of its liability. It was then entitled to allocate ACT as it saw fit.

It might also be noted that the Treaty only refers to tax payable under the laws of Canada and in accordance with the Treaty. No reference is therefore made to provincial taxation. The Board of Inland Revenue has, however, examined a number of foreign taxes to see whether or not they qualify for double taxation credit relief under the terms of a treaty or under U.K. domestic law. Admissible taxes include generally provincial mining taxes and logging tax. Inadmissible taxes include the Federal (now repealed) petroleum and gas revenue taxes on capital taxes based on a percentage of premiums received by insurance companies at the provincial level and mining tax levied under the Alberta Freehold Mineral Taxation Act 1973. Similarly, the Alberta oil and gas conservation tax is inadmissible.

I. TREATY SHOPPING

The dividend, interest and royalty provisions of the Treaty contained the normal OECD wording in relation to beneficial ownership as a qualification for entitlement to Treaty benefits. This is somewhat narrowly construed in the United Kingdom and is considered to refer merely to beneficial as opposed to normal ownership of the asset in question.

The Second Protocol, which introduced a 10% rate of withholding on interest and royalties that are subject to U.K. tax, as well as the provisions for refund of ACT in relation to dividends have removed considerably any incentive for treaty shopping by Canadian investors. Although dividends in relation to direct investment are subject to a 10% withholding after refund of half ACT (as opposed to 5% under treaties with the Netherlands and United States). However, since the renegotiation of the Canada–Netherlands Treaty to introduce an overall 10% rate of withholding on dividends distributed by Dutch companies to Canada, makes the insertion of a Dutch holding company to own a U.K. subsidiary unattractive.

2. 1986 BTC 188.

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The Canadian Approach to Anti-Avoidance Provisions

Background to the New Anti-Avoidance Rule

David A. Ward*

To understand differences between the Canadian and British judicial approaches to tax avoidance, the differences in tax appeal procedures are important.

Tax appeals in Canada proceed, like any other litigation, before a trial court which renders the decision at first instance.[1] Either party may appeal to the Federal Court of Appeal and with leave to the Supreme Court of Canada. Appeals are not by stated case; rather they are conducted on the same basis as other litigation. The appellant urges the Appellate Court to reverse the decision of the trial judge on matters of law, or, sometimes, by reversing the findings of fact.

Because appeals to the Appellate Court are not by way of stated case in Canada, the Appellate Courts have more easily been able to deal with tax avoidance cases by dealing with findings of fact without the necessity of establishing new principles of law.

> (I)t is the duty of the Court to carefully scrutinize everything that a taxpayer has done to insure that everything which appears to have been done, in fact, has been done in accordance with applicable law. It is not sufficient to employ devices to achieve the desired result without insuring that those devices are not simply cosmetically correct, that is, correct in form, but, in fact, are in all respects legally correct, real transactions. If this Court, or any other Court, were to fail to carry out its elementary duty to examine with care all aspects of the transactions in issue, it would not only be derelict in carrying out its judicial duties, but in its duty to the public at large.[2]

In a case of this kind, where it is acknowledged that what is sought by a certain course of action is a tax advantage, it is the duty of the Court to examine *all* of the evidence relating to the transaction in order to satisfy itself that what was done resulted in a valid, completed transaction.[3]

> It does not seem to be in doubt that the reason for the scheme ... was to achieve tax advantages .... While this does not affect the result actually achieved by what was done, it does, in my view, warrant a very careful appraisal of the evidence when considering whether what was projected with that end in view was actually carried out.[4]

This Canadian approach should be contrasted with the United Kingdom practice in which the Commissioners are the sole finders of fact. In some cases, judges hearing appeals seem to have attempted to encourage the Commissioners generally to be more aggressive in their findings in tax schemes:

> To my mind the Commissioners were entitled to see these people as they really are, prospectors digging for wealth in the subterranean passages of the Revenue, searching for tax repayments.[5]
>
> We were asked, what is this if it were not trading? If I had to give any answer, I would call it a cheap exercise in fiscal conjuring and bookkeeping phantasy, involving a gross abuse of the *Companies' Act* and having as its unworthy object the extraction from the Exchequer of an enormous sum which the appellant had never paid in tax and to which he had no shadow of a right whatsoever.[6]

This U.K. procedure of appealing by way of stated case has been criticized.

> (The procedure) creates injustice by denying the right of appeal on an issue of fact. Here in Great Britain in the twentieth century is a system of taxes where the State assesses the liability of the citizen by estimate and provides an appeal only to a court, staffed by amateurs or by State functionaries, that meets in secret, and whose factual findings are not subject to judicial review .... Injustice often occurs, and would be more frequent but for the care and objectivity usually displayed by the Commissioners.
>
> The stated case has survived so long, in spite of its clear injustice in many cases, because it suits so many of those engaged in appeals. It is irksome for the Commissioners and for the advocates to have to reveal to the gaze of the judges their notes of evidence: failure to weigh evidence and poor advocacy are both covered up by the stated case. An appeal on fact can be wearisome and embarrassing.[7]

It is suggested that because the Canadian courts have been able to deal with facts as well as with law in tax litigation, not only at the trial level but on appeals, Canadian judges have been less constrained than their English brethren in dealing with the most extravagant of the abuse cases. The aggressive tax planner in Canada has often, although not always, come to grief because judges, in tax avoidance cases, have been willing to make findings of fact adverse to the taxpayer if there is any evidence to support such facts, or if such facts can be inferred in any way from evidence given. Sometimes it has been said that the "smell test" is applied to tax avoidance cases in Canada. Examples include the following cases:

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1. At present this can, at the election of the taxpayer, be before the Tax Court or the Federal Court-Trial Division. Appeals from the Tax Court are to the Federal Court-Trial Division and are tried de novo. Tax trials in the Federal Court-Trial Division are to be abolished.
2. *Atinco Paper Products Ltd. v. The Queen*, (1978) *Canadian Tax Cases* ("C.T.C.") 566, Federal Court of Appeal, 78 *Dominion Tax Cases* ("D.T.C.") 6387.
3. *The Queen v. Daly*, (1981) C.T.C. 270, Federal Court of Appeal, 81 D.T.C. 5197.
4. *A. Rose v. M.N.R.*, C.T.C. 74, Federal Court of Appeal, 73 D.T.C. 5083 (1973).
5. *Griffiths v. J.P. Harrison Ltd.*, (1962) 1 *All England Reports* ("All E.R.") 909, per Lord Denning (dissenting) at 918 (HL).
6. *Johnson v. Jewitt* (1961), 40 *Tax Cases* ("T.C.") 231 per Donovan, L.J. 225 (Court of Appeal).
7. D.C. Potter "Tax Appeals", (1970) *British Tax Review* 38 at 41.

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(a) *A. Rose v. M.N.R.*:[8] The Court of Appeal found facts to be different than those "assumed" by the trial judge in a tax avoidance case, which led to the defeat of the tax plan.

(b) *Smythe v. M.N.R.*:[9] The Supreme Court of Canada found, as a fact, that assets of a corporation had been distributed or appropriated to the shareholders on the winding-up, discontinuance or re-organization of its business (and they were deemed to receive a dividend) where a corporation sold its business for cash and concurrently the shareholders sold their shares to dividend strippers for the same amount, less a 5% discount.

(c) *Richardson Terminals v. M.N.R.*:[10] The purported transfer of a business to an affiliated loss corporation in order to absorb the losses was found, as a matter of fact, not to have taken place.

(d) *Susan Hosiery Limited v. M.N.R.*[11] and *Westhill Redevelopment Co. Ltd. v. M.N.R.*:[12] The court held that deductions claimed for substantial payments made into pension plans which were immediately wound up and distributed to the officers of the company who then re-lent the funds to the company failed on the evidence that there was no bona fide employees' pension plan created or established for income tax purposes.

(e) *Produits L.D.G. Products Inc. v. The Queen*:[13] Here the court reversed the trial judge and found a pension plan was not a sham (and could not be ignored therefore for tax purposes) because although the funds paid into the plan were repaid to the employer corporation on the issuance of preferred shares to the plan, the plan, unlike those in the *Susan Hosiery* and the *Westhill Redevelopment* cases, continued to exist.

(f) *Atinco Paper Products Ltd. v. The Queen*:[14] The court found that transactions had been imperfectly carried out in law and their intended tax avoidance effect therefore failed.

(g) *Dominion Bridge Co. v. The Queen*:[15] The court, affirmed on appeal, held that an offshore subsidiary through which reinvoicing profits were made is not in fact conducting its own business but rather part of its parent corporation's business and the profits were therefore those of the parent, the Canadian taxpayer.

(h) *Massey-Ferguson v. The Queen*:[16] The Appellate Court, reversing the trial judge's decision, found that the taxpayer had correctly carried out its intended tax avoidance transaction, and so was entitled to the relief claimed.

After some initial flirting by lower courts with a broad business purpose test and its extended concept of a "sham", the Supreme Court of Canada like the House of Lords (in *Craven v. White*)[17] has rejected the use of this technique for striking down tax avoidance transactions. The test urged by the Revenue, as formulated in the *Stubart* case (which is the same as urged by the Revenue in *Craven v. White*) was:

> a proposition that a transaction may be disregarded for tax purposes *solely* on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose.

In *M.N.R. v. Leon*[18], Heald, J. had said:

> It is the agreement or transaction in question to which the court must look. If the agreement or transaction lacks a bona fide purpose, it is a sham.

In dealing with the *Leon* case in the later appeal of *Stubart Investment Ltd. v. The Queen*[19], Estey, J. for the Supreme Court said:

> The statement of Heald, J., supra, was not essential to the conclusion reached by the court .... The Federal Court, in enunciating the rule, supra, cut across the United States bona fide business purpose principle which sharply distinguishes between transactions which fail because they are shams in the sense of the deception, and those which fail because they lack an independent business purpose.

The landmark *Stubart* case did, however, indicate that the Canadian courts would come to the same conclusions (perhaps by different routes) that the House of Lords did in the *Ramsay, Burmah Oil* and *Dawson cases*.[20] In considering these 3 English cases, Estey, J. indicated that there is a much more flexible Canadian approach in dealing with tax avoidance cases, in part because of an ability to deal with findings of fact in tax appeals, and in part, because Canadian courts do not now follow the English courts in strictly construing taxing statutes, but seek to find their "object and spirit".

In dealing with the *Ramsay* case, he said:

> (T)he momentary theoretical existence of an accounting quantity which does not survive the whole transaction has no existence in the taxing process. It may be that a fleeting existence is reality in the discipline of particle physics but not in the law of taxation unless it is specifically so enacted.

In dealing with the *Burmah Oil* case he said:

> There are features about that case and its disposition that must be noted when considering its application in our law. The transaction created an accounting result which was then applied to reduce taxes otherwise exigible. The taxpayer did more than rearrange its affairs to avail itself of the statutory tax allowance. It was not, in my view, the non-arm's length ideas radiating out of

8. See footnote 4.
9. (1969) C.T.C. 558, 69 D.T.C. 5381.
10. (1971) C.T.C. 42 (Ex. Ct.), 71 D.T.C. 5028, affirmed (1972) C.T.C. 528 (S.C.C.), 72 D.T.C. 6431.
11. (1969) C.T.C. 533 (Ex. Ct.), 69 D.T.C. 5346.
12. (1969) C.T.C. 581 (Ex. Ct.), 69 D.T.C. 5385.
13. (1976) C.T.C. 591 (F.C.A.), 76 D.T.C. 6344.
14. (1978) C.T.C. 566 (F.C.A.), 78 D.T.C. 6387.
15. (1975) C.T.C. 263 (F.C.T.D.), 75 D.T.C. 5150, affirmed (1977) C.T.C. 554 (F.C.A.), 77 D.T.C. 5367.
16. (1977) C.T.C. 6 (F.C.A.), 77 D.T.C. 5013.
17. (1988) *Simon's Tax Cases* 476.
18. (1976) C.T.C. 532, (F.C.A.), 76 D.T.C. 6229.
19. (1984) C.T.C. 294 (SCC), 84 D.T.C. 6305.
20. *Ramsay (W.T.) Limited v. IRC*, (1981) 54 *Tax Cases* 101; *IRC v. Burmah Oil Company Limited*, (1982) 54 *Tax Cases* 200; and *Furniss v. Dawson*, (1984) 55 *Tax Cases* 324.

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the central control of the corporate group that were fatal. It was the synthetic nature of the gain and the loss which rendered it unrecognizable in the eyes of the taxation program adopted by the legislature.

In dealing with the *Dawson* case he said:

> The taxpayers, in the simplest analysis of this plan, had merely established the new company to perform as agent for the taxpayers the sale agreement already reached between the taxpayer and the purchaser.

The judicially pronounced summary of the rules in Canada for dealing with tax avoidance cases was set out by Estey, J. in the *Stubart* case as follows:

> (1) Where the facts reveal no bona fide business purpose to the transaction, section 137 [which deals with expenditures that 'unduly or artificially' reduce income] may be found to be applicable depending upon all the circumstances of the case.
> (2) In those circumstances where section 137 does not apply, the older rule of strict construction of a taxing statute, as modified by the courts in recent years, prevails but will not assist the taxpayer where: (a) the transaction is legally ineffective or incomplete or, (b) the transaction is a sham within the classical definition.
> (3) Moreover, the formal validity of the transaction may also be insufficient where:
> (a) the setting and the Act of the allowance, deduction or benefit sought to be gained clearly indicates a legislative intent to restrict such benefits to rights accrued prior to the establishment of the arrangement adopted by a taxpayer purely for tax purposes;
> (b) the provisions of the Act necessarily relate to an identified business function. This idea has been expressed in articles on the subject in the United States:
> 'The business purpose doctrine is an appropriate tool for testing the tax effectiveness of a transaction, where the language, nature and purpose of the provision of the tax law under construction indicate a function, pattern and design characteristic solely of business transactions';
> (c) the 'object and spirit' of the allowance or benefit provision is defeated by the procedures blatantly adopted by the taxpayers to synthesize a loss, delay or other tax saving device, although those actions may not attain the heights of 'artificiality' in section 137. This may be illustrated where the taxpayer, in order to qualify for an 'allowance'; or a 'benefit', takes steps which the terms of the allowance provisions of the Act may, when taken in isolation and read narrowly, be stretched to support. However, when the allowance provision is read in the context of the whole statute, and with the 'object and spirit' and purpose of the allowance provision in mind, the accounting result produced by the taxpayer's actions would not, by itself, avail him of the benefit of the allowance.[21]

Canada's proposed new anti-avoidance rule, Sec. 245, is not to "apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of (the) Act or an abuse having regard to the provisions of (the) Act ... read as a whole."

Therefore, the new section is much narrower than the business purpose test as urged on the courts by the Revenue in *Stubart* and in *Craven*. It is a fair question, therefore, to ask, in the end, whether new Sec. 245, adds very much to Guideline 3 and, in particular, 3(c)? Although the concept of abuse of law is a continental or civil law concept, not a common law concept, it would appear that to make a finding that there has been a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act (the essence of the new Statutory rule), one must find that the facts would also fall within Guideline 3, presumably most often Guideline 3(c). In other words, a court must look to the "legislative intent" or the "object and spirit" of the Act, before it could find an "abuse" or a "misuse" as contemplated by new Sec. 245. The question is: is there any real difference between the application of the judicial rule and the statutory rule?

The general anti-avoidance rule seems to have been put in place in Canada because of a failure in the Departments of Finance, Justice and National Revenue to understand the recent British and Canadian jurisprudence.

Early in the process, the Government seemed to think Canada had no jurisprudential anti-avoidance rules.

> What led the Government to propose a general anti-avoidance rule? Within the Canadian commercial community there has developed a profusion of sophisticated tax-motivated strategies involving various technical provisions that yield unintended and significant tax advantages. The Government is concerned that without a rule which can counteract these arrangements, which erode the tax base and bring the tax system into disrepute, the objectives of tax reform will not be achieved ... The new direction in dealing with tax avoidance signalled by the White Paper stems from a number of recent events, including the decision of the Supreme Court in the *Stubart* case.[22]

Later it was said that the English and United States rules were the same, and Canada had no such rules:

> The Department also believed that the new general anti-avoidance rule was required because the guidelines set out by Mr. Justice Estey in the *Stubart* case were not founded on a business purpose test. Mr. Allan Short, General Director, Legislation (Department of Finance), said:
>
> > 'What we are attempting to do is by legislation ensure that the business purpose test which really is the same in the United States as in the United Kingdom will apply in Canada so that a transaction that has no purpose other than a tax avoidance purpose will not be recognized.'[23]

Finally, after criticism from the tax community, the Government seemed to admit that Canadian courts had developed anti-avoidance rules, but the problem

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21. It is interesting how close Mr. Justice Estey's Guideline 3 is to the analysis of the *Furniss v. Dawson* "New Approach", by Lord Oliver of Aylmerton in *Craven v. White*.
22. David A. Dodge, Assistant Deputy Minister of Finance, at the 1987 British Columbia Tax Conference, September 1987.
23. Report, House of Commons Committee, on the White Paper on Tax Reform Stage I, November 1987.

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was that aggressive tax advisors had not understood them accurately.

> (T)he volume of tax-motivated strategies that have been marketed after *Stubart* suggests that the message in *Stubart* has not been clearly understood or that the proposed test has not been as effective as it appeared that it would be ... Guideline 3(c) of *Stubart* specifically refers to 'procedures blatantly adopted by the taxpayer to synthesize a loss' as one of the cases where the spirit and object of a provision are defeated and where the taxpayer should not be able to avail himself of the benefit or allowance. Yet a number of tax practitioners have obviously considered that the test proposed in *Stubart* is not sufficient to curtail this particular abuse.[24]

Whether one deals with Guideline 3(c) or the general anti-avoidance rule, the real question, as an editor of the *British Tax Review* said in reviewing 2 recent reports on the "New Approach", is: "How do we ensure that judges get the intentions of Parliament right?"

In all or almost all countries which have the abuse concept (including the United States) there is no Hansard Rule to restrict the court from using all tools available to find the intent of the statute.

Some judges in Canada seem to be moving away from the Hansard Rule, although the Supreme Court has not approved this trend.[25] As the recent appeal in *The Queen v. Bronfman Trust*[26] shows, when the courts have no access to such sources, guesses as to legislative intent can be very far off the mark:

> Parliament created Sec. 20(1)(c)(i) [the provision dealing with interest deductions] and made it operate notwithstanding Sec. 18(1)(b), in order to encourage the accumulation of capital which would produce taxable income.

With respect, an examination of *Hansard* at pages 4,492-4,508 shows no such intention.

24. David A. Dodge, "A New and More Coherent Approach to Tax Avoidance", *Canadian Tax Journal,* January-February 1988 at 17.
25. See *Lor-West Contracting Ltd. v. The Queen,* (1985) 2 C.T.C. 79 (F.C.A.), 85 D.T.C. 5310; *Canterra Energy Ltd. v. The Queen,* (1985) 1 C.T.C. 329 (F.C.T.D.), 85 D.T.C. 525; *A.G. v. Reader's Digest Association,* (1961) C.T.C. 530 (S.C.C.), 61 D.T.C. 1273 and *Morguard Properties Ltd. v. Winnipeg,* (1983) 2 *Supreme Court Reports* (S.C.R.) 493. However, in *The Queen v. Vasil* (1981) 1 S.C.R. 469, Lamer, J., although commenting that reference to Hansard is not usually available, did refer to it to learn whether the adoption by Canada in the Criminal Code of various provisions in the English Draft Code of 1878 was based on reasons advanced by an English Royal Commission.
26. 87 D.T.C. 5059 (S.C.C.).

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The Canadian Approach to Combat Tax Avoidance

The Early Aftermath

Howard J. Kellough*

I. BACKGROUND

There is no apparent single event or clear progression of calculated steps that can be pinpointed as leading to the introduction of Canada's general anti-avoidance rule ("GAAR"). It seems to have developed over the last few years and dawned on Department of Finance officials as an idea whose time had come. There are, it is suggested, a few events which in hindsight helped plant the seeds for what has grown and become known as GAAR:

- Federal Budget of 12 November 1981: some signs of things to come. A Department of Finance bureaucracy out of control.
- Severe economic decline starting in 1981-82: this seemed to encourage tax related "entrepreneurship".
- Scientific research tax credit applicable after September, 1983: a Government fiasco which was used to support an aggressive anti-avoidance tax policy.
- Federal Budget of 23 May 1985: the beginning of the level playing field notion.[1]
- Announcement of tax reform in 1986 and the need to act quickly following dramatic changes announced in the United States: the necessity to lower rates in line with the United States accelerated the level playing field notion which included as part of the package a revenue-generating general anti-avoidance rule.
- Decline in corporate revenues for 1985-86 of C$ 1.2 billion below Budget (actual corporate income tax revenue was C$ 9.210 billion for 1985-86): Government said this decline was mainly due to the unexpectedly large application of loss carryforwards.
- In 1986, the Department of Finance estimated the "tax overhang" (the tax value of unused losses and credits) at C$ 18.5 billion as at 1982 and likely at C$ 25.0 + billion at 1986 (1988-89 budgetary revenues were projected at C$ 103.3 billion and expenditures of C$ 132.3 billion): this was considered an unacceptable drain on revenues. Specific anti-avoidance rules and GAAR are intended to limit access to those and other deductions.

II. WHY THE PERCEIVED NEED FOR A BROADER GENERAL ANTI-AVOIDANCE RULE?

- Existing general and specific anti-avoidance provisions were ineffective in combating tax avoidance which was viewed as comprising an ever-increasing array of tax avoidance schemes.
- Existing judicial doctrines were considered ineffective.
- The *Stubart Investments Limited*[2] case was viewed as having rejected the notion of a general business purpose test.
- The judicial developments in the United Kingdom (*Furniss v. Dawson*[3] and the long-standing U.S. "business purpose test" arising from *Helvering v. Gregory*[4] gave support to introduce similar tests in Canada. Canada was seen as fiscally underdeveloped in light of the developments in other countries.

III. WHY THE STATUTORY APPROACH?

The Government was unwilling to let the law develop judicially (along with basic amendments to the existing general anti-avoidance rule) through a more aggressive litigation of perceived avoidance transactions. This process was believed to be too slow, uncertain and probably (most of all) inadequate to tame aggressive tax advisors. Support for the legislative approach was taken from papers such as the study by the Revenue Law Committee of The Law Society in the United Kingdom, "Tax Law in the Melting Pot".

An article by Peter Millett, "Artificial Tax Avoidance – The English and American Approach"[5] was handed out to members of the Canadian Bar Association/Canadian Institute of Chartered Accountants Joint Committee on Taxation by a senior official of the Department of Finance as support for the Government's proposal (at the time) for the adoption of a general business purpose test. In his article Millett, of course, expressly opposes the codification of a business purpose test. He thinks it should be left as judge-made law, the great advantage of which, he says, is that "it is based on principle, and unlike statute law, cannot be undermined by microscopic examination in the search for loopholes". He might also have added that, unlike statute law, it is easier to mould in order to avoid untoward results.

Support for Millet's position can be found in Lord Scarman's speech in *Furniss v. Dawson* where he offered some thoughts as to where the U.K. step transaction doctrine might be headed. He stated:

The Law will develop from case to case. Lord Wilber-

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1. *Editor's note:* This phrase basically refers to a system in which all tax distortions are removed.
2. 84 *Dominion Tax Cases* ("D.T.C.") 6305 (SCC).
3. (1984) 1 *All England Reports* ("All E.R.") 530 (H.L.).
4. 69 Fed. 2d 809 (2d. Cir. 1945), aff'd. by the Supreme Court, 293 United States 465 (1935).
5. No. 6 *British Tax Review* (1986) at 327-39.

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force in [*Ramsay's* case] referred to 'the emerging principle' of the law. What has been established with certainty by the House in Ramsay's case is that the determination of what does, and what does not, constitute unacceptable tax evasion is a subject suited to development by judicial process. The best chart that we have for the way forward appears to me, with great respect to all engaged on the mapping process, to be the words of Lord Diplock in [the *Burmah Oil* case] which my noble and learned friend Lord Brightman quotes in his speech. These words leave space in the law for the principle enunciated by Lord Tomlin [the *Duke of Westminster's* case] that every man is entitled if he can to order his affairs so as to diminish the burden of tax. The limits within which this principle is to operate remain to be probed and determined judicially. Difficult though the task may be for judges, it is one which is beyond the blunt instrument of legislation. Whatever a statute may provide, it has to be interpreted and applied by the courts; and ultimately it will prove to be in this area of judge-made law that our elusive journey's end will be found.

The study by the Revenue Law Committee of the U.K. Law Society recommended a statutory rule to replace the *Dawson* principle[6] with such modification as Parliament may think fit. The Committee's objections to the *Dawson* principle were based upon "its unpredictable operation, the open acknowledgements by their Lordships that the principle will be developed further by judicial decision, and the constitutional objections posed by their Lordships embarking on judicial lawmaking in an area of law which is the creature of statutes."[7] The Department of Finance took refuge in the fact that they were in the shadow of such an esteemed body which advocated a similar approach to combat tax avoidance. However, they did not heed the Law Society's caution not to enact an anti-avoidance provision that was framed in the widest possible terms.

The Canadian approach to combat tax avoidance through legislation is an indication of the extraordinary degree to which legislation can be misshaped into a blunt instrument (see below).

Quaere: Would the U.K. Revenue Law Committee advocate the same approach in light of the limitations that appear to have been placed on the application of the *Dawson* principle by the House of Lords in *Craven H.M.I.T. v. White; Baylis (I of T) v. Gregory;* and *CIR v. Bowater Property Developments Ltd.* and the Canadian legislative approach?

IV. WHAT DOES THE CANADIAN RULE CATCH?[8]

1. *Avoidance transactions* (Sec. 245(3)) mean any transaction
   (a) that would result in a tax benefit *unless* the transaction may
      – reasonably be considered
      – to have been undertaken or arranged
      – primarily
      – for bona fide purposes
      – other than to obtain the tax benefit
   (b) that is part of a series of transactions ...., etc.
2. Tax Benefits (Sec. 245(1)) means a reduction, avoidance or deferral of tax or other amount payable under the Income Tax Act ("ITA"), or an increase in a refund of tax or other amount.

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6. *Editor's note:* For a discussion of the *Dawson* principle, see "The Grin of the Cheshire Cat in Alice", 23 *European Taxation* 9 (1983) at 302 and "Wiping the Grin Off the Cheshire Cat's Face", 24 *European Taxation* 4 (1984) at 134.
7. See pages 1 and 2 of the Committee Study.
8. New Sec. 245 reads as follows:

(1) In this section and in subsection 152(1.11),
"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;
"tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;
"transaction" includes an arrangement or event.
(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.
(3) An avoidance transaction means any transaction
(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaking or arranged primarily for bona fide purposes other than to obtain the tax benefit; or
(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.
(4) For greater certainty, Subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section read as a whole.
(5) Without restricting the generality of Subsection (2),
(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
(b) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,
(c) the nature of any payment or other amount may be recharacterized, and
(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored, in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.
(6) Where with respect to a transaction
(a) a notice of assessment, reassessment or additional assessment involving the application of Subsection (2) with respect to the transaction has been sent to a person, or
(b) a notice of determination pursuant to Subsection 152(1.11) has been sent to a person with respect to the transaction
any person (other than a person referred to in paragraph (a) or (b) shall be entitled, within 180 days after the day of mailing of the notice, to request the Minister to make an assessment, reassessment or additional assessment applying Subsection (2) or to make a determination applying Subsection 152(1.11) with respect to that transaction.
(7) Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this Section, shall only be determined through a notice of assessment, reassessment, additional assessment or determination pursuant to Subsection 152(1.11) involving the application of this Section.
(8) Upon receipt of a request by a person under Subsection (6), the Minister shall, with all due dispatch, consider the request, and

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Comment

Avoidance transactions appear to be defined exhaustively; but see Sec. 245(4), discussed below, which states that "for greater certainty" Sec. 245(2) does not apply to particular transactions. The implication is that because transactions covered by Sec. 245(4) are not caught by Sec. 245(2), these transactions are not "avoidance transactions". Clearly, transactions that fall within both Subsecs. 245(3) and 245(4) will not be avoidance transactions.

Quaere: Although it is implicit that transactions coming within Sec. 245(4) are not avoidance transactions, is it because:
(a) Sec. 245(4) type transactions do not result in a tax benefit?
(b) Sec. 245(4) transactions meet the purpose test?
(c) Some Sec. 245(4) transactions do not result in a tax benefit and the rest meet the purpose test?

A transaction will not be considered an avoidance transaction if there is no attendant tax benefit or if the "purpose test" is met. The Government announced changes to the definition of "avoidance transaction" in its 16 December 1987 release. Prior to that change the purpose test was restricted to transactions that could "reasonably be considered to have been carried out primarily for bona fide business purposes". The change was made because of the restrictive nature of a business purpose test which, strictly speaking, refers to a business context "and that, consequently, transactions carried out in a non-business context may fail the business purpose test, even if they are carried out primarily for non-tax purposes".[9]

The definition of "avoidance transaction" makes the scope of GAAR extraordinarily wide. Few, if any, transactions will not have attendant tax benefits. All transactions with attendant tax benefits will be avoidance transactions unless the various above-noted subjective/objective tests can be met or Sec. 245(4) is applicable.

(a) on the basis of that request and notwithstanding Subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to Subsection 152(1.11) with respect to that person, or
(b) reject the request and thereupon notify the person of his rejection by registered mail.

(9) Paragraphs 56(1)(l) and 60(o) and Divisions I and J, as they relate to an assessment or a reassessment and to assessing or reassessing tax, are applicable, with such modification as the circumstances require, to the rejection of a request made pursuant to Subsection (6) as if it were an assessment.

(10) Subsection (1) is applicable with respect to transactions entered into on or after the day on which this Act is assented to other than
(a) transactions that are part of a series of transactions, determined without reference to Subsection 248(10) of the said Act, commencing before the day on which this Act is assented to and completed before 1989, or
(b) any one or more transactions, one of which was entered into before April 13, 1988, that were entered into by a taxpayer in the course of an arrangement and in respect of which the taxpayer received from the department of National Revenue, before April 13, 1988, a confirmation or opinion in writing with respect to the tax consequences thereof.

9. See David A. Dodge, "A New and More Coherent Approach to Tax Avoidance", 36 *Canadian Tax Journal* (Jan.-Feb. 1988) at 1.

V. POSSIBLE CONSEQUENCES OF ENGAGING IN AN AVOIDANCE TRANSACTION

1. Charging provision (Sec. 245(2))

The tax consequences are to be determined as is reasonable in the circumstances in order to deny the tax benefit.

Comment

The ambit or scope of Sec. 245 is restricted only by the charging provision which requires the transaction to be a defined avoidance transaction. No discretion can be exercised by Revenue Canada authorities in raising an assessment under Sec. 245 where the transaction constitutes an avoidance transaction; a mandatory determination must be made by Revenue Canada whenever a defined avoidance transaction exists.

Quaere: Should Revenue Canada be given a legislative basis not to apply Sec. 245 notwithstanding its technical application so that they have a basis at law to apply administrative policy?

2. Determining the tax consequences (Sec. 245(5))

- deduction, etc. allowed or disallowed
- deductions, losses, etc. may be allocated to any person
- recharacterization of any payment or other amount
- ignore tax effects arising from other provisions

Comment

The Minister has wide latitude in the nature of the reassessments issued where GAAR applies. A taxpayer's liability can be determined "as is reasonable in the circumstances" in order to deny the tax benefits. Among other things, the Minister may recharacterize the offensive payments, deductions, etc. This could affect third parties to a transaction who would be forced to request adjustments to their income tax position.

The Explanatory Notes to Bill C-139 state that

> Sec. 245(3) does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in arranging one's affairs so as to attract the least amount of tax – is a legitimate and accepted fact of Canadian tax law.

VI. APPEAL PROCEDURES

Taxpayers assessed under GAAR will follow the normal appeal procedures under the ITA. Taxpayers will be able to appeal the determination of the tax consequences as well as the determination that the transaction in question constituted an avoidance transaction.

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A third party who is affected by a recharacterization of a transaction may request adjustments of a relieving nature with respect to the same transaction (Sec. 245(6)). The request must be made within 180 days of the notice sent to the primary taxpayer. It has been assumed that the reassessment will always be brought to the timely attention of affected third parties.

VII. ESCAPE HATCHES

1. Avoidance transaction definition

The transaction must
- reasonably be considered
- to have been undertaken or arranged primarily
- for bona fide purposes
- other than to obtain the tax benefit

Comment

The transaction must be one undertaken or arranged for purposes other than the attainment of a tax benefit. Thus, it is not the result of the transaction that matters (it may yield a tax benefit) but rather the purpose. Satisfactory purposes would be those for business, family, investment and perhaps others.

The argument has been put forward that the word "purpose" refers to the transaction in question and would be determined in an objective manner by looking at the facts, namely what the taxpayer did and the legal, commercial and tax results thereof.[10]

The counter-argument is that transactions do not have purposes per se but instead "'purpose' connotes an intention by some person to achieve a result desired by him".[11] Thus, the taxpayer's motive may come into question when determining the purpose. Even if Arnold's view is held to be the case, there are a number of difficult propositions to overcome regarding the purpose test.

(1) The determination of the purpose refers to a point in time before the transaction is undertaken or arranged. The evidentiary problems may prove difficult. A well-documented transaction is essential.

(2) The taxpayer must prove a negative ("other than to obtain the tax benefit"). The evidentiary problems inherent in such tests have proven difficult for taxpayers to overcome in other sections of the ITA (e.g. Sec. 247(2)).

(3) The purpose must be bona fide. On balance, this seems to require an objective determination and means "not fictitious or colourable, but real and genuine to all intents and purposes.[12] However, it is a further requirement the taxpayer must prove.

(4) The non-tax purposes must be the primary purposes. A weighing and balancing will be necessary where both tax and non-tax purposes are present to determine the primary (more than 50%?) purposes.

(5) Finally, all of the foregoing must stand up to a test of reasonableness. This may give Revenue Canada some latitude in deciding what transactions constitute avoidance transactions.

The operation of the statutory step transaction test (Sec. 245(3)(b)) is described in the Explanatory Notes as "where a series of transactions would result in a tax benefit, that tax benefit will be denied unless the primary objective of each transaction in the series is to achieve some legitimate non-tax purposes...each step in such a series must be carried out primarily for bona fide non-tax purposes".

The statutory definition of "series of transactions" under Sec. 248(10) of the ITA as including any related transactions or events in contemplation of the series appears to be a much broader notion than the pre-ordained series of transactions notion considered most recently in the *Craven v. White,* etc. cases.

2. Misuse or abuse provision (Sec. 245(4))

- for greater certainty
- Subsec. (2) does not apply to a transaction where
- it may reasonably be considered that the transaction would not result directly or indirectly in
- a *misuse* of the provisions of the ITA, or
- an *abuse* having regard to the provisions of the ITA read as a whole

Comment

Revenue Canada and many advisors appear to be looking only at Sec. 245(4) and asking whether the particular transaction could be said to constitute a misuse or abuse. The balance of Sec. 245 seems to have been forgotten.

The Department of Finance has been glib regarding the application of Sec. 245(4) saying that in essence it is nothing more than "an analysis of the object and spirit of the provisions of the Act read as a whole in the context of each particular case"[13] as if it were a routine matter.

Sec. 245(4) raises at least 2 fundamental questions. First, at what stage in analyzing a transaction under Sec. 245 should Sec. 245(4) be considered? Second, does Sec. 245(4) in any way alter the accepted rules of statutory construction? Sec. 245(4) would appear to come into play only after a determination has been made that a particular transaction is a defined avoidance transaction.

Quaere: Does Sec. 245(4) create an alternative test with regard to the definition of an avoidance transaction notwithstanding that it is prefaced by the words "for greater certainty"

10. See Brian J. Arnold, "In Praise of the Business Purpose Test", in Report of Proceedings of the Thirty-Ninth Tax Conference (Toronto: Canadian Tax Foundation, forthcoming).
11. Lord Diplock in *Sweet v. Parsley,* (1909) 1 All E.R. 347 (HL).
12. See Lord Macnaghten in *Attorney-General v. Richmond (Duke) No. 1),* (1909) Appeals Court 466 (HL).
13. See Dodge, supra.

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which implies that the provision is simply to clarify what already has core meaning?

Whether Sec. 245(4) alters the accepted rules of statutory construction is a subject beyond the scope of these intended brief notes. The following observations suggest, however, that there is either a resulting modification of the existing rules of statutory construction or the provision is incapable of being satisfied.

(1) The notions of misuse and abuse start from the presumption that a transaction in question has been found to be an "avoidance transaction" within the literal working or "true" meaning of the ITA.
(2) The process of defining the true meaning of a word, phrase, etc. starts by recognizing that no word has an absolute and unchangeable meaning in every context. A court must have regard to a number of factors such as dictionary definitions and the usual principles of statutory interpretation such as "expressio unius, noscitur a sociis or ejusdem generis".
(3) The object and spirit test only has application where there is an ambiguity. Where there is an ambiguity, one of the factors a court might look at in determining its true meaning is the object and spirit of the provision in which that word is found. However, the object and spirit is only one factor a court would consider in finding the true meaning.
(4) Assuming there is no ambiguity, the object and spirit test will not have application. However, it would appear that even in the absence of an ambiguity Sec. 245(4) would apply and thereby potentially lead to the alteration of a provision that has a clear and unequivocal meaning.
(5) Even where there is an ambiguity, the object and spirit test is only one factor a court may have regard to in its interpretation. Moreover, in searching for the object and spirit of a particular provision a court must have regard to the actual words of a provision. The court is not entitled to determine for itself what it feels the object and spirit is without having regard to the intention of Parliament as it appears from the actual words used. It is for this reason that Parliamentary debates are usually disregarded in determining the object and spirit of a particular provision.
(6) Because a transaction will have been determined to fall within the meaning of an avoidance transaction, a court must decide what Parliament would have done had it not enacted the GAAR. This means that having concluded that a transaction comes within the literal wording of the ITA (i.e., after considering its object and spirit) as an avoidance transaction, the court must decide whether this is a transaction Parliament would have allowed had Parliament realized such a transaction was possible.
(7) This analysis is to venture into the hypothetical and engage in a fictitious hunt for legislative intent which, for other purposes, the Supreme Court of Canada has rejected[14].

If these interpretive problems can be overcome, there are a number of concerns that remain not the least of which is the search for evidence of the "misuse" and "abuse".

The Joint Committee on Taxation has recommended that Sec. 245(4) be amended to require the Minister to establish the facts upon which it may reasonably be considered that the transaction would result in a misuse or abuse.

VIII. ADMINISTRATIVE PRACTICES

1. Explanatory Notes

An earlier version of GAAR contained Sec. 245(10) which provided: "In interpreting this section, recourse may be had to any Explanatory Notes thereto provided by the Minister of Finance who shall cause such Notes to be published in the Canada Gazette forthwith on the coming into force of this section". Submissions were made by the Joint Committee on Taxation that at law the Notes would be of little value in assisting in the interpretation of GAAR. Indeed, Sec. 245(10) gave a false sense of comfort to many who were quoting the Notes as the proper interpretation of GAAR. Sec. 245(10) has been deleted from Bill C-139.

2. Comments by Revenue Canada officials

Some very general and somewhat confusing statements have been made by Revenue Canada officials as to the administration of GAAR:

(a) Deputy Minister – April, 1988

- In normal circumstances where, for example, an individual transfers his business to a corporation primarily to obtain the small business deduction and expects to defer the recognition of gains on the property transferred, the transaction would not be a misuse of Subsec. 85(1) or an abuse of the Act read as a whole.
- In summary, we do not perceive that this provision will have a significant impact on our administration of the law except to the extent that transactions yield tax advantages unintended by Parliament.
- Revenue Canada will provide advance rulings on GAAR and is committed to release further information prior to implementation.
- In the longer term, after experience is gained, Revenue Canada will issue an Interpretation Bulletin.

(b) Director General Rulings – June, 1988

Examples given of transactions that may or may not be misuse or abuse of the ITA.

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14. See Dickson, J., in *Regina in Right of Canada v. Saskatchewan Heat Pool*, (1983) 3 W.W.R. 97.

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The United Kingdom Approach to Anti-tax Avoidance Provisions

Stephen Edge*

THE GENERAL APPROACH TO COMBATING TAX AVOIDANCE

General

The United Kingdom has not enacted any general anti-tax avoidance section or other provisions in its tax legislation. Further, under its general tax law there is no general principle that the substance of a transaction should take precedence over its form. The principal approach to anti-tax avoidance provisions in the United Kingdom has proceeded primarily through the enactment of specific legislation to deal with particular loopholes or abuses. Since 1981, however, there have been important case law developments whereby certain types of anti-tax avoidance schemes have been overturned by an approach which has ignored the effects of certain intermediate transactions undertaken solely for tax avoidance purposes.

Statutory anti-avoidance provisions

Traditionally, tax avoidance in the United Kingdom has been combated by enacting specific legislation to deal with particular abuses. Frequently such legislation is retroactive to the date on which it was announced and, in a few rare cases, has even been retrospective to some earlier date.

Two of the most important statutory anti-avoidance provisions relating to international transactions are the controlled foreign company legislation and Secs. 765-767 of the Income and Corporation Taxes Act 1988, which requires advance Treasury consent for certain share and loan transactions. Other important anti-tax avoidance legislation relating particularly to international transactions includes:

- Secs. 739-746 Income and Corporation Taxes Act 1988 dealing with transfers of assets abroad by individuals (e.g. into offshore companies and offshore trusts);
- Sec. 15 Capital Gains Tax Act 1979 taxing individuals and certain closely-owned companies on capital gains arising through foreign companies;
- Secs. 757-760 Income and Corporation Taxes Act 1988 taxing gains arising from the disposal of interests in offshore funds as income; and
- Secs. 770-774 Income and Corporations Taxes Act 1988 dealing with transfer pricing.

There are numerous anti-tax avoidance provisions aimed primarily at domestic transactions but which may potentially affect international transactions. Some notable examples include:

- Secs. 703-709 Income and Corporation Taxes Act 1988 relating to the cancellation of tax advantages from certain transactions and securities;
- Sec. 775 Income and Corporation Taxes Act 1988 which seeks to tax as income capital sums derived by individuals from the sale of rights to income relating to their personal activities;
- Sec. 776 Income and Corporation Taxes Act 1988 taxing as income certain capital gains arising from the disposal of land in the United Kingdom, including gains from certain share transactions; and
- Sec. 125 Income and Corporation Taxes Act 1988 disallowing a deduction for certain annual payments made for non-taxable consideration.

Frequently particular anti-avoidance provisions may potentially have a wider impact than appears to have been originally intended when they were introduced. A typical example is Sec. 125 Income and Corporation Taxes Act 1988 which was introduced to counteract an artificial tax avoidance arrangement known as the "reverse annuity" scheme. However, it potentially has much wider implications and it has been argued that it could operate to deny tax relief for certain payments under currency and interest rate swaps and under certain royalty arrangements.

Case law

Traditionally, the United Kingdom courts have not followed the approach adopted in certain other countries of looking to the substance of the transaction rather than its form. As a general principle, the form of a transaction would be followed for taxation purposes unless the transactions are a sham. The leading case establishing this principle is *IRC v. Duke of Westminster*.[1] In this case, the Duke of Westminster sought to obtain a deduction for wages paid to a gardener on his private estate by paying him under a deed of covenant. This turned what would have been non-deductible wages into what was then a deductible annual payment. An attempt by the Inland Revenue to deny the deduction on the grounds that the payments under the deed of covenant were effectively wages was refused.

An important modification of the form over substance principle has, however, appeared in a line of major cases determined over the last 7 years in relation to certain artificial tax avoidance schemes. Very high tax rates in the late 1970s led to the proliferation of artificial tax avoidance schemes which appeared to be developing faster than the loopholes they were exploiting could be plugged by specific anti-avoidance legislation. Perhaps as a result of this, a far-reaching decision was made by the House of Lords (the highest court in the United Kingdom) in the case of *Ramsay (W.T.) Limited v. IRC*.[2] In this case, whilst the principles of

* Tax Partner, Slaughter & May.

1. (1936) 19 *Tax Cases* ("T.C.") 490.
2. (1981) 54 T.C. 101.

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the Duke of Westminster case were affirmed, it was nevertheless decided that in relation to a wholly artificial tax avoidance scheme involving a series of circular transactions which ended up with no material overall cost (other than the fees to the scheme's organizers) but which appeared to produce a tax loss which the taxpayer sought to offset against other gains, the Courts could ignore intermediate transactions in the scheme which had no business purpose other than tax avoidance in order to overturn the scheme.

Following the decision in the *Ramsay* case, there was a long debate as to how far the principles stated in the case could be applied to other tax avoidance schemes or arrangements. At one extreme, certain tax inspectors appeared to argue that its principles could be applied to attack all kinds of transactions motivated by tax avoidance. At the other extreme, arguments were put forward to try to limit its application to other artificial tax avoidance schemes of a circular nature.

The Inland Revenue successfully applied the *Ramsay* principle in certain other cases decided by the House of Lords, notably *IRC v. Burmah Oil Company Limited*[3] and in *Furniss v. Dawson.*[4] The latter case dealt with a scheme common in the latter 1970s of seeking to avoid capital gains tax on the sale of a company by arranging the sale of the company first to an Isle of Man (or other tax haven) company on a share-for-share transaction in respect of which a roll-over of the capital gain was then available. This case confirmed the application of the *Ramsay* principle to non-circular transactions.

A very important series of cases on the *Ramsay* principle were decided only in July 1988 by the House of Lords. These cases were *Craven v. White, IRC v. Bowater Property Developments Limited,* and *Baylis v. Gregory.*[5] In these cases the House of Lords appeared to impose a clear limitation on the further development of the *Ramsay* principle by deciding 3 cases on tax avoidance schemes in favour of taxpayer (albeit in *Craven v. White* only by a 3-2 majority). These cases indicated that application of the *Ramsay* principle was confined to a series of transactions containing an intermediate transaction designed to avoid tax where the following conditions were satisfied:

(i) the series of transactions was, at the time the intermediate transaction was entered into, pre-ordained in order to produce a given result;
(ii) that the intermediate transaction had no other purpose than tax mitigation;
(iii) that there was, at that time, no practical likelihood that the pre-planned events would not take place in the order ordained so that the intermediate transaction was not even contemplated practically as having an independent life; and
(iv) that the pre-ordained events did in fact take place.

It has been suggested by certain senior tax inspectors from the Head Office Technical Division of the Inland Revenue that the *Ramsay* principle might be applied to counteract interest and royalty conduit arrangements utilizing finance and royalty companies located in countries with favourable double taxation treaties. However, following the *Craven v. White* decision, this would be questionable in most situations.

3. (1982) 54 T.C. 200.
4. (1984) 55 T.C. 324.
5. (1988) *Simon's Tax Cases* 476.

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UNITED KINGDOM:

Secs. 765-767 and Controlled Foreign Companies Legislation

N.J. Prentice*

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I. SECS. 765-767

A. Introduction

Secs. 765-767 Income and Corporation Taxes Act ("ICTA") 1988 (and its predecessor, Sec. 482 ICTA 1970) were enacted at a time when there were exchange controls in the United Kingdom but no controlled foreign companies legislation. The objectives of the original legislation would appear to have been to:

(i) prevent avoidance of U.K. direct taxation by the migration of companies outside the scope of the U.K. legislation;
(ii) prevent the disguised emigration by transfer of business activities from a U.K. resident company to a non-U.K. resident person;
(iii) enable the Treasury to exercise a degree of control over the issue or transfer of share capital and borrowings of non-U.K. resident subsidiaries of U.K. resident companies;
(iv) ensure that the Inland Revenue had notice of any loss of U.K. tax which might result from consent being granted; and
(v) enable the Treasury (acting on Inland Revenue advice) to impose conditions for the giving of consents such that loss of U.K. tax would be avoided or reduced.

It is ironic that at the end of 1981 when the Inland Revenue first published draft Controlled Foreign Corporation ("CFC") legislation and other proposals to counter international tax avoidance, the first draft clause included a provision to cause Sec. 482 to cease to have effect. At that time, the Inland Revenue's view was noted as being that "Section 482 is inappropriate following the abolition of exchange control .... but Section 482 should not be repealed unless there is an effective definition of company residence (and also measures to guard against avoidance through tax haven subsidiaries)".

However, we now have CFC legislation and a new statutory incorporation test of residence but Sec. 482 remains, as Secs. 765-767 ICTA 1978 on the statute book, albeit in a weaker format following modification in 1988 and the publication of new blanket consents for certain classes of transactions (see text below).

B. Original scope of provisions

As originally enacted, these anti-avoidance provisions enabled the Treasury to monitor 4 specific kinds of transactions:

(1) "for a body corporate resident in the United Kingdom to cease to be so resident".

For this purpose, the "central management and control" test of residence is applied and the provisions apply to both U.K. and foreign-incorporated companies. It should be noted that prior to 1988 there was no tax charge arising on emigration, although certain anti-avoidance provisions might have applied in some cases, notably Sec. 278 ICTA 1970 (company ceasing to be a member of a group);

(2) "for the trade or business or any part of the trade or business of a body corporate so resident to be transferred from that body corporate to a person not so resident".

This provision is drawn widely and could include, for example, the sale of a U.K. subsidiary by a U.K. holding company because, for this purpose, the holding of investments is treated as a business;

(3) "for a body corporate so resident to cause or permit a body corporate not so resident over which it has control to create or issue any shares or debentures".

Control is defined as majority voting or other control and includes indirect control so that all lower tier foreign subsidiaries would be under the control of the ultimate U.K. parent. Debentures would include most forms of indebtedness so that (3) would invariably

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apply to any new finance (debt or equity) of an overseas subsidiary;

(4) "except for the purpose of enabling a person to be qualified to act as a director, for a body corporate so resident to transfer to any person, or cause or permit to be transferred to any person, any shares or debentures of a body corporate not so resident over which it has control, being shares or debentures which it owns or in which it has an interest".

This would apply to the sale of a foreign subsidiary or to a reorganization of overseas subsidiaries. As an example, the Inland Revenue have attempted to use (4) to prevent U.K. multinationals from organizing an overseas holding company (a "mixer" company) in situations where there might have been an advantage from the blending of foreign tax rates for U.K. foreign tax credit purposes.

C. 1988 modifications

As noted above, the reasons for retention of the provisions after the abolition of U.K. exchange controls in 1979 (and the introduction of CFC legislation in 1984) remain unclear. Questions had also been raised about the incompatibility of the provisions with the Treaty of Rome as was examined in the *Daily Mail* case.[1]

In Finance Act 1988, which was enacted on 29 July 1988, (1) and (2) above have been deleted from the scope of the provisions ((3) and (4) having been left in place without amendment) with effect from 15 March 1988. It should be noted, however, that the repeal of these provisions is coincident with the introduction of the new incorporation test of residence and the tax charge arising on the emigration of a U.K. resident company.

D. Form of consent

The legislation allowed the Treasury to grant consent specially or, alternatively, to publish blanket categories of consents called 'general' consents. Rather quaintly, a consent "shall be published in such a way as to give any person entitled to the benefit of it an adequate opportunity of getting to know of it, unless in the opinion of the Treasury publication is not necessary for that purpose".

In the case of a special consent, written application would be made to the Treasury, in which information would be provided to respond to up to 30 'questions' set out in the Treasury's published questionnaire. The Treasury would consult the Inland Revenue before responding to the application and the consent would typically include conditions and a time period during which the consent was valid.

For a number of years, a limited number of general consents existed, but following a period of review new general consents were published in March 1988 to coincide with the repeal of (1) and (2). Details of these are provided in Appendix A and the following are the principal categories of transactions that are now consented to (subject to certain prescribed conditions) generally in relation to non-U.K. resident subsidiaries:

(i) creation of new shares;
(ii) issue of shares to shareholder in same overseas country;
(iii) issue of non-redeemable shares to a U.K. group company;
(iv) issue of shares to a third party or existing shareholders;
(v) transfer of shares or debt to a third party;
(vi) sale of shares or debt to a third party; and
(vii) transfer of shares or debt to a company in the same overseas country as the transferor.

E. Penalties

The prescribed transactions are unlawful without prior Treasury consent and the criminal provisions are exacted. A person who is guilty of an offence (which would include individuals who were party to the transaction) shall be liable on conviction or indictment:

(a) to imprisonment for not more than 2 years or to a fine or both; and
(b) when the person in question is a body corporate, to a fine but not exceeding an amount equal to 3 times the tax payable during the 3 years immediately before the offence.

In practice, because of the wide ranging scope of the provisions and their technical nature, many transactions occur without prior consent. In genuine cases, although there is no ability for the Treasury to allow a retrospective consent, the Treasury are usually prepared to confirm that no action would be taken.

II. CONTROLLED FOREIGN COMPANIES LEGISLATION (CFC)

A. Introduction

The controlled companies legislation was introduced in 1984 after a period of over 3 years of consultation and debate, and is one of the most significant changes ever introduced for multinational companies based in the United Kingdom. The basic purpose of the legislation was to counter the apparent abuse of certain U.K. resident companies sheltering profits from U.K. taxation by means of companies established in tax havens or low tax territories. The legislation is somewhat similar to provisions in the United States (sub-part F), Canada (FAPI), France, West Germany and Japan.

During the consultation period, the Revenue stated that they believed the loss of tax to the Exchequer could have been some £ 100 million per annum. Published statistics for the year ended 31 March 1987 indicate that the yield is only £ 13.3 million, although the Inland Revenue also indicate that it is 'forcing' the distribution of profits to the United Kingdom, or using

1. *R v. HM Treasury, ex parte Daily Mail,* [1987] Simon's Tax Cases 157.

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up other available tax reliefs, to the extent of some £ 80 - £ 120 million per annum.

B. Charge to tax

A charge to tax can only be imposed on a U.K. resident company that has (together with any connected or associated person) a 10% or more interest in the CFC. Overseas resident companies are outside the scope of the CFC legislation as are individuals, trusts or other entities not subject to corporation tax.

The charge is not automatic and only arises as a consequence of a specific direction by the Board of the Inland Revenue. In particular, companies are not required to take any action, make any returns or supply information unless requested to do so by the Inland Revenue. The tax charge is based upon an apportionment of the CFC's chargeable income (i.e. excluding capital gains) which is computed on the assumption the CFC is resident in the U.K.

C. Definition of a CFC

A company is a CFC if:
(i) it is resident outside the United Kingdom, and
(ii) it is controlled by persons resident in the United Kingdom, and
(iii) it is subject to a lower level of taxation in the territory in which it is resident.

The first condition is simply a reflection of the scope of U.K. corporation tax, which applies to all U.K. resident companies.

1. Resident outside the U.K.

The territory of residence is specifically defined for this purpose as the territory in which it is liable to tax by reason of "domicile, residence or place of management". If 2 or more territories satisfy this requirement then a series of tie-breaker tests exist, as follows:
(1) The place of effective management has priority.
(2) If effective management occurs in more than one territory, the company will be resident in the one in which the greater amount of the company's assets is situated.
(3) If there is no place of effective management so that neither (1) nor (2) apply, the company will be resident in the territory in which the greater amount of the company's assets are situated.
(4) If none of the above applies, the Revenue will specify in a direction, the relevant country of residence.

Care should be taken to ensure that the company is liable to tax by virtue of its domicile, residence or place of residence; otherwise it is conclusively presumed to be resident in a territory subject to a lower level of taxation, e.g. if a company is only liable to tax by virtue of a source of income in a territory then it will automatically be a CFC if controlled from the United Kingdom.

2. Controlled by U.K. residents

The overseas company must be "controlled" by persons resident in the United Kingdom (for this purpose the interests of all U.K. residents are taken into account although, as noted above, only companies are taxed under these provisions). Control is widely defined and broadly corresponds to the definition for closely-held companies. In addition to covering the straightforward position of owning (directly or indirectly) greater than half the share capital, the definition is extended to cover most situations where U.K. residents have real economic control of the overseas company. This would include the right to receive the greater part of the income of the company or the greater part of its assets on a winding up.

3. A lower level of taxation

This condition is satisfied if the overseas tax actually payable on the potential CFC's income in the territory of residence is less than one-half that which would have been payable if the potential CFC had been U.K. resident and subject to U.K. corporation tax. Taxation of chargeable gains is excluded from both calculations.

Notional corporation tax is computed on the assumption that the CFC is neither a member of a group of companies nor a member of a consortium but is entitled to most of the normal tax deductions and that all claims and elections are made to give maximum relief, subject to request for variations by the controlling company. Relief for trading losses only in the 6 years prior to the direction by the Board of the Inland Revenue is available, which contrasts with the normal position in the United Kingdom where trading losses can be carried forward indefinitely.

In many cases it will be necessary to compute the notional U.K. tax liability each year as it will not be obvious merely from the overseas tax rate whether or not the potential CFC is subject to a lower level of taxation. This would be the case where, for instance, overseas corporate tax deductions or reliefs are particularly favourable when compared with the United Kingdom. For example:
- accelerated tax depreciation
- investment incentives, e.g. tax holidays or "pioneer" relief
- deduction of expenses including goodwill/know-how, etc.
- non-taxation of overseas income, e.g. dividends/branch

The Government agreed, in view of the practical difficulty of requiring every U.K. group to make annual calculations to determine if a particular company was a CFC, the Inland Revenue should publish a list of what are known as excluded countries, the original version of which is attached as Appendix B. The purpose of the list, which has no force of law, is, in effect, to record the Inland Revenue's undertaking that no direction would be made in respect of a CFC based in one of the excluded countries if 90% of its 'commercially quantified income' is 'local source income'.

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'Commercially quantified income' means profits determined according to generally accepted accounting principles excluding capital gains or losses. 'Local source income' is that which is treated under a country's own laws as accruing in, arising, or being derived from that country and which is within its charge to tax, i.e. is actually chargeable there or covered by a specific exemption from the general charge. Income derived from a branch or agency located in a third country is not 'local income'.

The list is divided into 2 parts. CFCs resident and carrying on a business in countries listed in Part I are excluded in all cases whereas for those countries listed in Part II the company will be excluded provided that it does not benefit from certain specified local reliefs.

Thus no direction will be made in respect of a CFC resident and carrying on business in Canada which is in Part I. The United States is in Part II of the list, meaning that all CFCs will be excluded under this test other than those benefiting from the Domestic International Sales Corporations legislation. Another example of a company not qualifying under Part II would be a Belgian coordination centre.

There are, however, practical problems with the list. For example, a company resident in Canada but deriving, say, 20% of its income from a branch in the United States would not be able to qualify under this test despite the fact that both jurisdictions are themselves excluded countries.

D. The 5 exemptions

1. De minimis limit

No direction will be made if the CFC's chargeable profits (computed in accordance with U.K. corporation tax rules) do not exceed the rate of £ 20,000 per annum. There are no provisions to reduce this limit in relation to the number of associated CFCs.

2. The exempt activities test

A CFC which fulfils the following conditions is exempt if:

(a) it occupies and uses, with a reasonable degree of permanence, premises in the territory of residence for the purposes of a trade; and

(b) it effectively manages its business affairs in its country of residence; and

(c) either

(i) its main business is neither an "investment business" nor "dealing in goods for delivery to or from the United Kingdom, or to or from connected or associated persons" (unless actually delivered in the CFC's territory of residence).

If the company is mainly engaged in wholesale, distributive or financial business less than half its gross trading receipts must be derived from connected parties.

An investment business is defined to include:

- Holding securities, patents or copyrights
- Dealing in securities
- Leasing
- The investment of funds by or on behalf of any associated or connected person.

Wholesale, distributive or financial business includes

- Dealing in any description of goods wholesale rather than retail
- Shipping or air transport
- Banking or any similar business
- Administration of trusts
- Dealing in securities as a broker
- Dealing in commodity or financial futures
- Insurance business which is long-term business or general business, as defined in Sec. 1 of the Insurance Companies Act 1982.

Special rules apply in determining the extent of a bank's transactions with associated or connected companies

or

(ii) The CFC is a 'local holding company' which derives at least 90% of its gross income from companies which it controls, are resident in the same territory, are not themselves holding companies and otherwise satisfy the exempt activities test;

or

(iii) A holding company which is not a local holding company but which derives at least 90% of its gross income from companies which it controls and which are either local (as defined) holding companies or are not holding companies but still engaged in exempt activities.

3. The acceptable distribution policy (ADP)

If it is impossible to avoid a direction by means of one of the other tests this will often be the most appropriate pro-active approach. This test requires a trading company to distribute a dividend exceeding 50% of the available profits for the accounting period to persons resident in the United Kingdom within 18 months of the end of the accounting period. The percentage is increased to 90% in respect of non-trading companies.

A reduction in the percentage distributed to the United Kingdom is permitted where shares are held by unconnected non-resident persons and either there is only one class of share issued or both a class of non-voting fixed rate preference shares and one class of voting shares.

Special rules exist in order to track the passage of dividends through intermediary holding companies to the United Kingdom and to prevent a dividend from being double counted in respect of 2 different CFCs. A further condition was introduced in 1987 whereby the ADP is only available if the dividend is paid when the company is non-U.K. resident. This prevented the meeting of this test by importation of a CFC and the distribution of its earnings to the U.K. parent as a tax-free intergroup dividend whilst still technically satisfying the requirements of the CFC exemption.

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4. The CFC is a publicly-quoted company

This test, which is likely to be of very limited application, is fulfilled if the CFC is publicly quoted in such a way that:

(a) at least 35% of the voting shares are beneficially held by the public, and
(b) no more than 85% of the total voting power is held by persons holding 5% or more each, and
(c) within the 12 months prior to the accounting period end the shares had been dealt in and quoted on the official list of a recognised stock exchange in the territory of residence.

5. The motive test

No direction will be made if the Board of the Inland Revenue are satisfied that:

(a) a reduction in U.K. taxes by diversion of profits from the U.K. was not the main reason or one of the main reasons for the company's existence, *and*
(b) for any transaction or transactions affecting the profits of the CFC which also caused a reduction in U.K. tax, either the reduction so achieved was minimal or it was not the main purpose or one of the main purposes of that transaction or transactions.

This is a highly subjective test and hence will often be difficult to satisfy. In practice, the Inland Revenue are most reluctant to accept a CFC meets this test alone.

6. Prevention of double taxation

The CFC legislation includes provisions designed to prevent a second charge to U.K. tax, in respect of the CFC's income subject to a direction, when profits are repatriated to the United Kingdom or the shares in the CFC are sold.

Relief in respect of dividends out of the apportioned income of a CFC will be given by treating as a deductible foreign tax credit the U.K. tax previously assessed under the CFC legislation. In normal circumstances no further liability will therefore arise. However, where the dividend has been subject to an overseas withholding tax the above procedures may not give full relief due to the foreign tax credit limitation imposed by the U.K. legislation. In this situation a repayment will be given equal to the withholding taxes arising on the dividend.

Where proceeds of the sale of a CFC are repatriated to the United Kingdom, then the U.K. company will be entitled to claim relief. An appropriate amount of the tax previously assessed on apportionment can be taken as a deduction in computing the capital gain arising on the disposal.

APPENDIX A

THE TREASURY GENERAL CONSENTS 1988

The Treasury, in exercise of the powers conferred on them by section 482(4) of the Income and Corporation Taxes Act 1970(a), hereby give the following consents:

Citation and Commencement

1. These consents may be cited as the Treasury General Consents 1988 and apply to transactions on and after 15th March 1988.

Interpretation

2. (1) In these consents unless the context otherwise requires –

"company" means a body corporate;

"non-resident company" means the body corporate referred to in section 482(1)(c) or (d)(a) which is not resident in the United Kingdom;

"overseas group" means two or more companies, including the non-resident company, which are not resident in the United Kingdom and which –

(a) are liable to tax in the same territory outside the United Kingdom by reason of domicile, residence or place of management, and

(b) would be deemed to be members of a group of companies for the purposes of section 258 of the Taxes Act if, in subsection (7) of that section (a) –

(i) the words "resident in the United Kingdom" were omitted, and

(ii) a reference to a body corporate not liable to tax in the territory outside the United Kingdom by reason of domicile, residence or place of management referred to in sub-paragraph (a) above were substituted for the reference to a body corporate not resident in the United Kingdom in paragraph (c) of that subsection;

"redeemable", in relation to shares, means that the shares satisfy one or both of the following conditions –

(a) that, by virtue of the terms of their issue, the exercise of a right by any person or the existence of any arrangements, they are liable to be redeemed, cancelled or repaid, in whole or in part;

(b) that, by virtue of any material arrangements, the holder has a right to require another person to acquire the shares or is obliged in any circumstances to dispose of them or another person has a right or is in any circumstance obliged to acquire them;

and arrangements are material arrangements if the company which issued the shares or a company connected with that company is a party to the arrangements;

"resident company" means the body corporate resident in the United Kingdom referred to in section 482(1)(c) or (d);

"resident group" means those companies, including the resident company, which are deemed to be members of a group of companies for the purposes of section 258 of the Taxes Act;

section 482(1)(c) and section 482(1)(d) means Taxes Act, as the case may be;

(a) 1970 c.10. By virtue of paragraph 21(3) of Schedule 30 to the Income and Corporation Taxes Act 1988 (C.L.) on and after 6 April 1988 the reference to section 482(4) is to be construed as a reference to section 765(4) of that Act, the reference to section 482(1)(c) or (d) is to be construed as a reference to section 765(1)(c) or (d) of that Act, the reference to section 258(7) is to be construed as a reference to section 413(5) of that Act and the reference to the purposes of section 258 is to be construed as a reference to the purposes of Chapter IV of Part X of that Act.

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"the Taxes Act" means the Income and Corporation Taxes Act 1970;

"territorial group" means two or more companies which are not resident in the United Kingdom and which –

(a) are liable to tax in the same territory outside the United Kingdom by reason of domicile, residence or place of management, and

(b) would be deemed to be members of a group of companies for the purposes of section 258 of the Taxes Act if, in subsection (7) of that section –

(i) the words "resident in the United Kingdom" were omitted, and

(ii) a reference to a body corporate not liable to tax in the territory outside the United Kingdom by reason of domicile, residence or place of management referred to in sub-paragraph (a) above were substituted for the reference to a body corporate not resident in the United Kingdom in paragraph (c) of that subsection;

"transaction" means a transaction of one of the classes described in section 482(1)(c) or (d) as the case may be;

and other expressions have the same meaning as in section 482 of the Taxes Act.

(2) The Interpretation Act 1978(a) shall apply to these consents as it applies to an Act of Parliament.

(3) In applying the provisions of section 258 of the Taxes Act for the purposes of the definitions of "overseas group", "resident group" and "territorial group" in sub-paragraph (1) above, the words "51 per cent. subsidiary" and "51 per cent. subsidiaries" shall be substituted for "75 per cent. subsidiary" and "75 per cent. subsidiaries" as the case may be, wherever they occur in that section.

(4) For the purposes of these consents, any question whether a person is connected with another shall be determined in accordance with the provisions of section 533(2) to (8) of the Taxes Act(b) (any provision that one person is connected with another being taken to mean that they are connected with one another).

3. The Treasury consent generally to transactions of the class described in section 482(1)(c) which consist of –

(a) the creation of shares by the non-resident company;

(b) the issue of shares by the non-resident company –

(i) to another member of the overseas group, or

(ii) subject to the conditions prescribed by paragraph 4, to the resident company or to another member of the resident group, or

(iii) subject to the conditions prescribed by paragraph 5, to a person not connected with the resident company, or

(iv) subject to the conditions prescribed by paragraph 6, to all persons who are its shareholders at the time of the issue;

(c) the creation of debentures by the non-resident company and their issue –

(i) to another member of the overseas group, or

(ii) subject to the condition prescribed by paragraph 7, to the resident company or to another member of the resident group, or

(iii) subject to the conditions prescribed by paragraph 5, to persons not connected with the resident company;

(d) transactions of any kind described in subsection (1)(c) where the non-resident company –

(i) was incorporated after 31st December 1951,

(ii) is liable to tax in a Commonwealth territory other than the United Kingdom by reason of domicile, residence or place of management, and

(iii) was incorporated for the purpose of starting and carrying on a new industrial activity in that Commonwealth territory,

and in this sub-paragraph "industrial activity" means any productive, extractive or manufacturing industry, any public utility, fisheries or any form of husbandry.

4. The conditions prescribed by this paragraph are that the issue –

(a) is of shares that are not redeemable; and

(b) is made either –

(i) for full consideration paid in cash to the non-resident company, or

(ii) in or towards payment for any business undertaking or property acquired by the non-resident company for full consideration.

5. The conditions prescribed by this paragraph are –

(a) that the issue

(i) is for full consideration paid to the non-resident company, and

(ii) is not to a nominee or trustee for a person who is connected with the resident company;

(b) that no arrangements exist as a consequence of which the resident company or a person connected with the resident company, or a nominee or trustee for that person or that company, is or may become entitled to the shares or debentures so issued or to any of them or to any interest in them or in any of them.

6. The conditions prescribed by this paragraph are that the issue

(a) is in respect of and in proportion to the shares held by the shareholders in the non-resident company at the time of the issue; and

(b) is either –

(i) of shares that are not redeemable, or

(ii) where no shares are issued to a company which is resident in the United Kingdom or to a nominee or trustee for such a company, for full consideration paid in cash to the non-resident company.

7. (1) The condition prescribed by this paragraph is that none of the circumstances set out in sub-paragraph (2) below are associated with, or are present in connection with, the issue of the debentures.

(a) that the debentures are issued at a discount;

(b) that arrangements exist as a result of which the non-resident company acquires property of any description from a company which is resident in the United Kingdom and the consideration, or some parts of the consideration, for the acquisition remains unpaid;

(c) that a loan, whether or not of the same amount as that secured by the debentures, is made by a company which is not resident in the United Kingdom to a company which is resident in the United Kingdom;

(d) that any amount payable in respect of the debentures is determined by reference to the movement of an index of prices, earnings or any other indicator of an economic nature published in the United Kingdom or elsewhere.

(a) 1978 c.30. (b) By virtue of paragraph 21(3) of Schedule 30 to the Income and Corporation Taxes Act 1988 (c.1) on and after 6 April 1988 the reference to section 533(2) to (8) is to be construed as a reference to section 839(2) to (8) of that Act.

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Consent to transactions within section 482(1)(d)

8. The Treasury consent generally to transactions of the class described in section 482(1)(d) which consist of –

(a) the transfer by the resident company of shares or debentures of the non-resident company to another member of the resident group;

(b) subject to the conditions prescribed by paragraph 9, the transfer by the resident company or by a company which is not resident in the United Kingdom (in paragraph 9 referred to in either case as "the transferor company") of shares or debentures of the non-resident company to a person not connected with the resident company;

(c) the transfer by a company which is not resident in the United Kingdom of shares or debentures of the non-resident company to a company which is a member of a territorial group of which the first-mentioned company is also a member.

9. The conditions prescribed by this paragraph are –

(a) that the transfer –

(i) is for full consideration paid to the transferor company, and

(ii) is not to a nominee or trustee for a person who is connected with the resident company;

(b) that no arrangements exist as a consequence of which –

(i) the resident company, or

(ii) a nominee or trustee for the resident company, or

(iii) a person connected with the resident company, or

(iv) a nominee or trustee for a person connected with the resident company,

is or may become entitled to the shares or debentures transferred or to any of them or to any interest in them or in any of them.

Revocation of previous consents

10. All consents previously given generally by the Treasury to transactions of the classes described in section 482(1)(c) and (d) are hereby revoked.

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16 July 1984

APPENDIX B

CONTROLLED FOREIGN COMPANIES

EXCLUDED COUNTRIES LIST AND CLEARANCE PROCEDURE

This press release deals with two matters relevant to the operation of the controlled foreign company provisions contained in Clauses 82-91 and Schedules 16-18 of the current Finance Bill. (These are the provisions which enable a charge to UK tax to be imposed on certain UK companies with interests in UK-controlled companies in low tax areas.)

First, the Government has today authorised the attached "list of excluded countries". This list, which incorporates a number of changes from the provisional version issued on 29 March 1984, will become definitive as soon as the Finance Bill receives Royal Assent.

Second, the Government has decided that the Inland Revenue should operate an informal clearance procedure in respect of the controlled foreign company provisions.

EXCLUDED COUNTRIES LIST

2. The purpose of the list of excluded countries is to give an assurance that a charge will not arise under the controlled foreign company legislation in respect of companies in countries named on the list. Where a company is resident and carrying on business in a listed country, it will be regarded as meeting the conditions for exclusion set out in the legislation itself. A provisional version of this list was issued on 29 March 1984. This version has now been amended in a number of respects, following the Economic Secretary's announcement during the Committee Stage debate on the Finance Bill that it would be revised to make it more useful to UK businesses operating abroad.

3. The most important of the revisions relates to the "caveat" formerly contained in paragraph 2 of the covering note to the 29 March list. This has now been dropped. The protection of the list – which effectively provides an automatic exclusion from the charge in respect of an estimated 90 per cent of all the overseas subsidiaries of British companies – can thus no longer be regarded as conditional. As a consequence of dropping the "caveat", the final list now covers 76 countries in all (compared with 92 on the provisional list).

4. Additionally the covering note sets out (at paragraphs 7-9) the procedure to be followed when amendments to this list are required. In most cases there will be a period of consultation before there is any change in a particular country's status under the list. The remaining revisions are designed to provide clearer definitions of the various terms used in the covering note.

CLEARANCE PROCEDURE

5. To supplement this list of excluded countries, the Inland Revenue will make available a clearance facility for those UK groups operating in countries not on the list. As the Economic Secretary made clear in the course of the Committee Stage debates, once the controlled foreign company legislation is enacted a technical unit in the Inland Revenue's Head Office will be available to provide:

i. advice on technical points in the interpretation of the legislation;

ii. advice on the application of the provisions to group structures, both existing and proposed (though not purely hypothetical);

iii. guidance on the treatment of other group subsidiaries where a UK company has been subject to a direction in respect of one of its overseas subsidiaries; and

iv. advance clearance where shares in a controlled foreign company are sold.

LIST OF EXCLUDED COUNTRIES: COVERING NOTE

1. This list relates to the provisions on Controlled Foreign Companies contained in Clauses 82-91 and Schedules 16-18 of the Finance (No. 2) Bill 1983/84. Its purpose is to give an assurance that, if a company is resident and carries on business in one of the countries on the list, it will be regarded as meeting the conditions necessary for exclusion from the charge imposed by the legislation.

2. The list is split into two parts. Any company which is resident and carrying on business (see paragraphs 3 and 4 below) in a country on Part I of the list will be excluded from the application of the legislation. Where a company is resident and carrying on business in a country which appears on Part II it will be similarly excluded, provided that it does not benefit from any of the reliefs specified in column 2.

3. For the purposes of this list a company will be treated as resident in a country if, under local law, it is liable to tax there by reason of domicile, residence or place of management. Where a country does not impose tax by reason of one of these criteria, incorporation will be the test used. Thus, a company will be treated as resident in the country under whose laws it is incorporated, if otherwise it would not be resident anywhere for the purposes of this list.

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4. A company will be regarded for the purpose of this list as carrying on business in a country if 90 per cent of its commercially quantified income is local source income. For the purpose

a. "commercially quantified income" means the profits as determined according to generally-accepted commercial accounting standards, but disregarding any profits or losses of a capital nature;

and b. "local source income" means income which is treated under a country's own laws as accruing in, arising in, or being derived from that country and which is within its charge to tax – i.e. is actually chargeable there or covered by a specific exemption from the general charge. Income derived from a branch or agency outside a country will not in any event be regarded as local source income of that country.

5. The list will apply by reference to the overseas company's accounting period. No charge will arise if, throughout an accounting period, the company is resident and carrying on business either in a Part I country or in a Part II country but not entitled to any of the reliefs specified in column 2.

6. The fact that a company fails to gain exclusion from the charge by virtue of this list does not, of course, necessarily mean that it comes within the charge. A charge can arise only where all the conditions set out in Clause 82 are present; and where they are all present the company may escape through satisfying one of the statutory tests for exclusion in Clause 83.

Changes to the list

7. The list will be amended from time to time, as necessary, to reflect tax changes made by the UK or by an overseas country or changes in the way in which the relevant laws are applied, or to reflect indications that the laws are capable of exploitation.

8. Where an amendment arises from a change in tax rates or tax law or practice, the Government will give notice of the proposed amendment and invite comments. If, in the light of consultations, the list is revised, the change to the list will apply for all accounting periods ending after –

either (a) the date on which the change in tax rates, or law or practice becomes effective;

or (b) the date on which the Government gave notice of the proposed amendment to the list,

whichever is the later.

9. Where the need to amend the list arises from indications that a country's existing law or practice is capable of exploitation, the revised list will apply for all accounting periods ending after the date on which the revised list is published.

Part I: Excluded Countries

Australia	Indonesia
Austria	Italy
Bangladesh	Ivory Coast
Belgium	Japan
Bolivia	Korea, Republic of
Botswana	Malawi
Brazil	Mauritius
Bulgaria	Mexico
Canada	Morocco
China	Netherlands
Columbia	New Zealand
Czechoslovakia	Nigeria
Denmark	Norway
Dominican Republic	Papua New Guinea
Falkland Islands	Poland
Fiji	Romania
Finland	Sierra Leone
France	South Africa (excluding the Homeland)
Gambia	Soviet Union
German Democratic Republic	Swaziland
German Federal Republic	Sweden
Ghana	Thailand
Honduras	Western Samoa
Hungary	Yugoslavia
India	Zambia

Part II: Excluded Countries, subject to qualifications

(1) *Country*	(2) *Qualification*
Argentina:	companies obtaining exemption from tax on income from transactions, activities or operations carried on in, or from goods located in, tax-free areas in accordance with Law 19640
Brunei:	companies qualifying as "pioneer companies" under the Investment Incentives Enactment 1975
Egypt:	1. companies outside the scope of Article III of Law 157 of 1981 because they do not "operate in" Egypt
	2. companies to which Articles 16 and 18 of Law 43 of 1974 (as amended by Law 32 of 1977) apply in circumstances where a dividend out of those profits to a UK resident company would not attract relief under Article 22(3) of the UK–Egypt Double Tax Agreement (SI 1091 of 1980) on account of the proviso to Article 22(3)(b)
Faroe Islands:	companies deriving interest from Faroese financial institutions from which tax is deducted at source under Law 4 of 26 March 1953
Greece:	1. companies which have profits exempt from tax under Article 6(2)(c) of Law 384 of 1958 (profits from the operation of ships under the Greek flag)
	2. companies which have established themselves in Greece under Law 814 of 1978 (offshore shipping and associated activities)
Ireland:	companies obtaining relief or exemption from tax under Part V of the Corporation Tax Act 1976 or Section 43 of the Finance Act 1980 (profits from trading within Shannon Airport)
Kenya:	1. companies having income granted exemption from tax under paragraph 11 Schedule 1 of the Income Tax Act 1973
	2. companies obtaining investment allowance under paragraph 24(1)(a) or (c) or paragraph 25 Schedule 2 of the Income Tax Act 1973
Lesotho:	companies obtaining initial, depreciation or investment allowances under Section 18 of the Pioneer Industries Encouragement Act 1969, as amended
Luxembourg:	companies obtaining any special tax benefit under the law of 31 July 1929, decree of 17 December 1938 as amended or Grand Ducal Regulation of 29 July 1977 (holding companies)
Malaysia:	1. companies exempt from tax in accordance with Section 54A of the Income Tax Act 1967 (shipping)

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(1) *Country*	(2) *Qualification*
	2. companies subject to tax at 5% in accordance with Section 60A of the Income Tax Act 1967 (inward reinsurance)
	3. companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above
Malta:	companies entitled to exemption or relief from tax under
	a. Section 8(2) of the Income Tax Act 1948, or
	b. Section 6B of the Aid to Industry Ordinance 1959
Pakistan:	companies deriving royalties, commissions or fees which are exempt from tax under paragraph 139, Part I, second Schedule, Income Tax Ordinance 1979
Philippines:	1. companies authorised under Presidential Decree 1034 or 1035, both of 30 September 1976, to operate an Offshore Banking Unit or a Foreign Currency Deposit Unit as defined in those decrees or the regulations thereto
	2. companies receiving interest on deposits with a Foreign Currency Deposit Unit, or other interest subject to the reduced rates of tax under Section 24(cc) of the National Internal Revenue Code
Portugal:	1. companies having income not charged to the industrial tax, but would have been so charged had the company been within group A of that tax
	2. companies which are investment or holding companies having a capital in excess of 100,000 Contos, and deriving dividends or interest from Portuguese securities
	3. companies obtaining the benefit of Article 44 of the Industrial Tax Code (reinvestment of reserves)
	4. companies obtaining a deduction from taxable income under Decree-Law 408/80 of 26 September 1980 (export incentives)
	5. companies obtaining any reduction in industrial, capital or complementary taxes by virtue of the Integrated System of Investment Incentives contained in Decree-Law 194/80 of 19 July 1980, other than by way of accelerated depreciation
Puerto Rico:	1. companies obtaining full or partial exemption from income tax or surtax under the Industrial Incentive Act 1978, in respect of income from a service industry or from property leased to and used by a business obtaining such exemption
	2. companies obtaining tax holidays in respect of income from exports, or in respect of the business of maritime transportation of freight or the lease or rental of property used in such transportation
Senegal:	1. companies receiving income from 'bons de caisse' which is not liable to the tax on industrial and commercial profits
	2. companies obtaining a reduction in the tax on industrial and commercial profits by reason of reinvestment of the whole or part of those profits
Singapore:	1. companies subject to the concessionary rate of tax for insurance and reinsurance of risks outside Singapore by virtue of Section 43C of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Income from Insuring and Reinsuring Offshore Risks) Regulations 1980
	2. companies subject to the concessionary rate of tax for specified Asian Currency Unit income by virtue of Section 43A of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations 1979
	3. companies obtaining exemption from tax on the income of a shipping enterprise in accordance with Section 13A of the Income Tax Act
	4. companies obtaining relief from tax in accordance with Sections 37A to K of the Economic Expansion Incentives (Relief from Income Tax) Act, as amended (international trade incentives)
	5. companies obtaining relief from tax in accordance with Sections 46J to S of the Economic Expansion Incentives (Relief from Income Tax) Act as amended (warehouses and service incentives)
	6. companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above
Solomon Islands:	1. companies having bank interest exempted from tax by Schedule 1(20) of the Income Tax Act (Chapter 61)
	2. companies carrying on life insurance business exempted from tax by Schedule 1(26) of the Income Tax Act
Spain:	companies obtaining tax credit relief for investments under the following or similar laws –
	a. Article 32 Law 1 of 1979
	b. Article 34 Law 42 of 1979
	c. Article 40 Royal Decree 3061 of 1979
Sri Lanka:	companies obtaining relief or exemption from income tax under any of the following provisions of the Inland Revenue Act (No. 28 of 1979)
	a. Section 8(c)(iv) – foreign currency banking units
	b. Sections 10(d) and 15(b) – income derived from approved bank accounts
	c. Section 10(e) – interest of newly resident companies
	d. Section 15(cc) – services rendered outside Sri Lanka
	e. Section 15(p) – re-export of approved products
Tanzania:	1. companies relieved or exempted from income tax under Section 15(1) or (1A) of the Income Tax Act 1973
	2. companies obtaining investment allowances under Schedule II Part V of the Income Tax Act 1973

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(1) *Country*	(2) *Qualification*
Trinidad and Tobago:	1. assurance companies carrying on long-term insurance business and liable to corporation tax at 15% on all or part of their profits in accordance with the proviso in Schedule III of the Finance Act 1966
	2. investment companies as defined by Section 46(3) of the Finance Act 1966 obtaining exemption from corporation tax on profits in accordance with Section 46(1)(b)
	3. approved property development companies entitled in accordance with Section 55A of the Finance Act 1966 to a deduction of 15% of capital expenditure incurred in the construction of a building used for commercial or industrial purposes by a lessee
	4. companies entitled to a deduction in computing chargeable income, in accordance with Section 2 of the Income Tax (In Aid of Industry) Ordinance 1950 (Chapter 33 No. 2) on the capital expenditure on construction of a building or structure which has been or is to be an industrial building or structure occupied for the purposes of a trade carried on by a lessee
	5. companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above
Tunisia:	companies obtaining exemption from or reduction of tax under Law 76-63 of 12 July 1976 (financial and banking institutions dealing with non-residents)
Turkey:	1. companies obtaining investment incentive allowances under Article 8(9) of Law 5422 of 3 June 1949 and Chapter VIII of Law 202 of 19 February 1963
	2. companies obtaining export incentives under Article 8(4), (6), (7), (8) or (10) of Law 5422 of 3 June 1949
United States:	Domestic International Sales Corporations as defined in Section 992(a) of the Internal Revenue Code 1954
Zimbabwe:	companies carrying on a "growth point business" as defined in Schedule 14 of the Income Tax Act 1967 as amended.

DIVIDENDS: CANADA–U.K. TREATY

		(a) Tax credit refund to "portfolio investors" Income	(a) Tax		(b) Tax credit refund to "direct investors" Income	(b) Tax	(c) No tax credit refund Income	(c) Tax
		£	£		£	£	£	£
Profit before tax of U.K. company		100.00			100.00		100.00	
Corporation tax at 35%		(35.00)	35.00		(35.00)	35.00	(35.00)	35.00
Dividend to foreign investor		65.00			65.00		65.00	
Tax credit/half tax credit		21.66	21.66		10.83	10.83	—	—
		86.66			75.83			
U.K. income tax on dividend plus credit/ half credit	(15%)	(12.99)	12.99	(10%)	(7.58)	7.58		
Net receipt by foreign shareholder		73.67			68.25		65.00	
Effective U.K. tax rate dividend			26.33			31.75		35.00

This form of calculation of the refund is in accordance with the *Texas Union* case decided last week to which I shall refer later.

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- Legislation
  releases 53, 54
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  releases 50, 51

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EEC

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Verlag Dr. Otto Schmidt, Cologne.

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Netherlands

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Editie J.M.M. Creemers
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- Algemene wet inzake rijksbelastingen
  release 58
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- AKBW, release 10
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- Algemene deel
  release 162
- Inkomstenbelasting 1964
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South Africa

LAW AND PRACTICE OF SOUTH AFRICAN INCOME TAX

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RECHTSBUCH DER SCHWEIZER BUNDESSTEUERN

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United Kingdom

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U.S. TAXATION OF INTERNATIONAL OPERATIONS

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Prentice-Hall, Inc., Englewood Cliffs.

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Conference Diary

FEBRUARY 1989

VAT Infraction Proceedings – Implementation of the European Court of Justice Judgement. London, 21 February (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

International Company Lawyers' Conference/Conférence Internationale des Juristes d'Entreprise. Cannes, 22-24 February (English and French):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

International Corporate Tax Planning – Recent developments. Monte Carlo, 23-24 February (English):
Worldwide Information, P.O. Box 161, 1820 Montreux 2, Switzerland.

European Employee Benefits Briefing – Trends and prospects – 1992 and beyond. Brussels, 27-28 February (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

MARCH 1989

Oort I en Oort II – Wat zijn de consequenties in de praktijk voor uw onderneming? Amsterdam, 1 March (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

Fundamental Elements of U.S. Federal Taxation. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S./International Taxation – Tax Strategies for Cross Border Activities. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S. Taxation: Oil and Gas – including International Aspects. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Foreign Investment in the U.S.: Strategies for Corporate Success. London, 14 March (English):
Dimitra Poulis, Business International Corp., 215 Park Avenue South, New York, NY 10003, U.S.A.

Münchner Steuerfachtagung 1989 – Steuerpolitik und Steuerrecht; Kapitalerträge und Zinsen nach der Steuerreform 1990; Aktuelle Fragen der Unternehmensbesteuerung; Verfahrensrecht; Internationales Steuerrecht – Europafragen. Munich, 15-17 March (German):
Münchner Steuerfachtagung e.V., c/o Lehrstuhl Prof. Dr. Klaus Vogel, Ludwigstrasse 28 Rückgeb., 8000 München 22, Federal Republic of Germany.

Het kopen en verkopen van participaties in B.V.'s. Rotterdam, 16 March (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Japanese Tax Reform. London, 21 March (English):
British Branch IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

Doing Business with China. Brussels, 23-24 March (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

APRIL 1989

The Inland Revenue's approach to captive insurance companies. London, 4 April (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

De BTW op drift? Rotterdam, 6, 13, 20 and 27 April, 2 May (Course). (Dutch):
PAO Belastingwetenschap, Postbus 533, 2300 AM Leiden, The Netherlands.

Fourth Residential Conference – Beyond 1992: A European Tax System? Oxford, 7-8 April (English):
Robert Markless Esq., The Institute for Fiscal Studies, 180 Tottenham Court Road, London W1P 9LE, United Kingdom.

European Acquisitions in the U.S. Brussels, 17-18 April (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

International Conference – China. Beijing and Shanghai, 23 April – 3 May 1989 (English):
The Taxation Institute of Australia, 7th Floor, 64 Castlereagh St., Sydney 2000, Australia.

Second East European Investment Seminar. Budapest, 26 April (English, German):
International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

Second East-West Tax Conference. Budapest, 27-28 April (English, German):
International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

International Taxation Management Techniques: Transfer Pricing Currency Management; Mergers and Acquisitions. Brussels, 27-28 April (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

MAY 1989

Seventh Annual Symposium organized by the Bureau of European Taxation & Trade on: The Taxation of Farming in Europe. London, 15 May (English):
Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, City of London, EC2Y 8DE, United Kingdom.

JUNE 1989

Taxation of Branches and Subsidiaries. Brussels, 1-2 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Fundamental Elements of U.S. Federal Taxation; U.S. Taxation of Corporate Reorganizations; U.S./International Taxation: Tax Strategies for Cross Border Activities. London, 5-10 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

NOVEMBER 1989

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

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Bruce Zagaris:

THE CARIBBEAN BASIN TAX INFORMATION EXCHANGE AGREEMENTS PROGRAM OF THE UNITED STATES – EAT SOFTLY AND CARRY A BIG STICK 115

Mr. Zagaris assesses the current status of the United States' tax information exchange agreements (TIEA) program of the Caribbean Basin Initiative (CBI). Most of the CBI beneficiary governments are unwilling to sign such agreements. Mr. Zagaris concludes that the TIEA program offers too little and asks to much of CBI governments. He offers various practical solutions to the problem: the United States should adhere to its agreements; full-fledged tax treaties which include tax information exchange and technical assistance should be negotiated; and incentives for the services sector should be enhanced.

M. Roger Moore and Nick C. Webb:

RESIDENCE IN THE UNITED KINGDOM AND THE SCOPE OF U.K. TAXATION FOR INDIVIDUALS – A CONSULTATIVE DOCUMENT 119

On 28 July 1988 the Inland Revenue issued a Consultative Document outlining proposals for a change in the rules which determine the tax residence status of an individual and the way in which this affects liability to U.K. taxation. One proposal would abolish the remittance basis of taxation currently available to individuals who are not domiciled in the United Kingdom; another proposal put forward in the Document would put an end to the rule that having accommodation available in the United Kingdom in conjunction with one day's presence in a tax year may be sufficient to make an individual resident for that tax year. These proposals are discussed in this article.

William T. Cunningham:

PORTUGUESE TAX REFORM: A CLOSER LOOK AT CORPORATE TAXATION 123

The corporate aspects of the recent Portuguese tax reform are effective as of 1 January 1989. Among the principal innovations of the tax reform are changes which will radically alter the timing and scale of obligations for companies. Mr. Cunningham examines these changes and outlines the persons liable to corporate tax, the taxable base and the implications for non-residents with and without a permanent establishment in Portugal.

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The most important change brought about in the 1988/1989 Budget is the introduction of separate taxation of married couples who previously were charged as one taxpayer on their combined income. A single scale of progressive rates of income tax for all individuals (married or single) was also introduced. The tax levied on trusts was also amended, i.e. the tax is now the same as that levied on companies. The rate of company tax has been reduced to 50%. These and other changes are discussed in this article.

Lee Fook Hong:

SINGAPORE: NEW TAX INCENTIVES 131

The Singapore Government recently announced a series of new tax incentives for Asian Currency Units, fund managers, securities companies, income from funds managed for foreign investors, oil traders and futures contracts for oil and other commodities. The particulars of these incentives are the subject of this article.

Rup Bahadur Khadka:

NEPAL: A SURVEY OF THE TAX SYSTEM 135

Many taxes, both direct and indirect, have been introduced in Nepal since the 1950s. However, more than 75% of the total tax revenue is derived from commodity-based taxes, i.e. customs duties, sales tax and excise duties. Direct taxes, such as income tax and property-based taxes, continue to play a small role in the Nepalese fiscal system. The author describes the development of taxes in Nepal and is of the opinion that direct taxes must be revamped if they are to achieve fiscal policy goals.

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ERRATUM

On page 546 of *Bulletin* 12 (1988) the text of the review of Resolution on Subject I (1988) is reproduced. Unfortunately in sub-paragraph b, 16th line, the text has been truncated. It should read:

". . . (i) of the State where participators entitled to a majority of their profits have their residence or (ii), . . ."

Please add the corrections in your copy.

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SOMMAIRE

Peter J. Connors:

Etats-Unis: Problèmes posés par les nouveaux produits financiers *104*
L'administration fiscale a annoncé en mai 1988 la formation d'un groupe spécial ayant pour tâche d'analyser les implications fiscales des nouveaux produits financiers. Cet article analyse 3 problèmes posés à l'administration fiscale par ces produits: les taux d'intérêts des crédits croisés, les contrats d'échanges des devises ainsi que les opérations conclues à titre de couverture à la suite de la décision *Arkansas Best.*

Bruce Zagaris:

Caraïbes: Le programme des Etats-Unis sur les accords d'échanges d'informations fiscales dans la Baie des Caraïbes – "Eat softly and carry a big stick" *115*
M. Zagaris analyse l'état actuel du programme des Etats-Unis sur les accords d'échanges d'informations fiscales (tax information exchange agreement: TIEA) du "Caribbean Basin Initiative" (CBI). La plupart des gouvernements bénéficiaires du CBI ne veulent pas signer de tels accords. M. Zagaris pense que le programme TIEA offre trop peu et exige trop des gouvernements CBI. Il présente différentes solutions au problème: les Etats-Unis devraient respecter leurs engagements; des conventions de double imposition complètes prévoyant l'échange d'informations fiscales et l'assistance technique devraient être négociées et les facilités fiscales devraient être augmentées dans le secteur tertiaire.

M. Roger Moore et Nick C. Webb:

Notion de résidence au Royaume-Uni et champ d'application de l'imposition des personnes physiques – Document Consultatif *119*
L'administration fiscale a publié le 28 juillet 1988 un Document Consultatif présentant, dans ses grandes lignes, un certain nombre de dispositions pour une modification des règles déterminant le statut de résidence fiscale d'une personne physique et dans quelle mesure celui-ci affecte son imposition au Royaume-Uni. L'une des dispositions supprimera l'obligation fiscale limitée aux revenus transférés, normalement applicable aux personnes physiques non domiciliées au Royaume-Uni; une autre disposition présentée dans le Document mettra fin à la règle selon laquelle le fait d'avoir une habitation disponible au Royaume-Uni combiné à une présence d'un jour dans ce pays peut être suffisant pour qu'une personne physique y soit considérée comme résidente pour cette année fiscale. Ce sont ces dispositions qui sont analysées dans cet article.

William T. Cunningham:

Portugal: Réforme fiscale portugaise – Etude de l'imposition des sociétés *123*
Les dispositions de la récente réforme fiscale portugaise applicables aux sociétés sont entrées en vigueur au 1er janvier 1989. Parmi les principales transformations introduites par la réforme fiscale il faut noter les modifications qui vont entièrement transformer la date du paiement de l'impôt, le nombre des contribuables et la charge fiscale supportée par les sociétés. M. Cunningham analyse ces modifications et mentionnne les personnes soumises à l'impôt sur les sociétés, la base imposable et les conséquences pour les non-résidents ayant, ou n'ayant pas, d'établissement stable au Portugal.

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D.G. Murphy:

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L'imposition séparée des époux est la modification la plus importante introduite par le Budget 1988/89; ils étaient autrefois imposés comme un seul contribuable pour l'ensemble du revenu du foyer. Un barême de taux progressifs pour l'impôt sur le revenu a également été introduit pour toutes les personnes physiques (mariées ou célibataires). L'impôt sur les trusts a également été modifié, ce qui signifie que le taux est maintenant le même que celui applicable aux sociétés. Le taux de l'impôt sur les sociétés a été réduit à 50%. Cet article analyse ces différentes modifications.

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INHALTSVERZEICHNIS

Peter J. Connors:

U.S.A.: Heutige Fragen betreffs neuer finanzieller Instrumente *104*
Die amerikanische Steuerverwaltung (Internal Revenue Service oder IRS) gab im Mai 1988 bekannt, dass ein Sonderausschuss formiert wurde, um die Steuerkonsequenzen, welche den neuen finanziellen Instrumenten inhärent sind, zu analysieren. Dieser Artikel beschreibt 3 Probleme, mit denen das IRS in Bezug auf diese Instrumente konfrontiert wird: die Zinsenratenkonversion, die ausländische Devisenkonversion und Hedginggeschäfte nach dem *Arkansas Best*-Urteil.

Bruce Zagaris:

Das karibische Gebiet: Das Programm der U.S.A. für Steuerinformationsaustauschabkommen im karibischen Gebiet: Zu wenig Anreize und zu viele Methoden, um die karibischen Staaten zu zwingen *115*
Herr Zagaris analysiert den heutigen Zustand des Programms für die Abschliessung von Steuerinformationsaustauschabkommen (TIEA Programm), das von den U.S.A. im Rahmen ihrer Initiative für das karibische Gebiet formuliert wurde. Die meisten karibischen Regierungen sind nicht bereit, solche Abkommen zu unterzeichnen. Herr Zagaris folgert, dass das TIEA Programm diesen Staaten zu wenig Vorteile bietet und zu viel von ihnen verlangt. Der Autor gibt eine Anzahl von praktischen Lösungen für dieses Problem – z.B. die U.S.A. sollten sich an ihre Abkommen halten; sie sollten Doppelbesteuerungsabkommen abschliessen, die Klauseln für den Austausch von Information und technische Unterstützung enthalten; und die Anreize für die Dienstleistungssektoren sollten erweitert werden.

M. Roger Moore and Nick C. Webb:

Der Wohnsitzbegriff im Vereinigten Königreich und der Umfang der britischen Steuerpflicht für natürliche Personen – ein „konsultatives" Dokument *119*
Die britische Steuerverwaltung (Inland Revenue) veröffentlichte am 28. Juli 1988 ein „konsultatives" Dokument, in dem sie eine Übersicht der Vorschläge zur Änderung der einkommensteuerlichen Wohnsitzbestimmungen für natürliche Personen gab, sowie der Art und Weise, auf die diese Änderungen die Steuerpflicht bezüglich der britischen Steuern beeinflussen. Einer dieser Vorschläge beinhaltet die Abschaffung der sogenannten "remittance basis" für die Erhebung der Einkommensteuer (d.h. in bestimmten Fällen werden ausschiesslich Einkünfte, die nach dem Vereinigten Königreich überwiesen werden, besteuert) für natürliche Personen, die kein „Domizil" in dem Vereinigten Königreich haben. Ein anderer im Dokument herausgestellter Vorschlag würde mit der Bestimmung, das der Besitz einer Wohnung im Vereinigten Königreich zusammen mit einem Aufenthalt von nur einem Tag während eines Steuerjahres bedeutet, dass man einen steuerlichen Wohnsitz im Vereinigten Königreich bekommt, Schluss machen. Diese Vorschläge werden in diesem Artikel besprochen.

William T. Cunningham:

Die portugiesische Steuerreform: Eine Nahaufnahme der Körperschaftsteuer *123*
Die Bestimmungen bezüglich der neuen portugiesischen Steuerreform treten ab 1. Januar 1989 in Kraft. Unter den wichtigsten Erneuerungen der Steuerreform befinden sich Änderungen, die eine radikale Umwälzung der Lasten betreffend Körperschaften, der Zeitpunkte und der Masse der auferlegten Verpflichtungen bedeuten. Der Autor analysiert diese Änderungen und beschreibt kurz, welche Gesellschaften der Körperschaftsteuer unterliegen, die Bemessungsgrundlage und Auswirkungen der neuen Gesetzgebung für beschränkt Steuerpflichtige mit oder ohne Betriebstätte in Portugal.

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D.G. Murphy:

Simbabwe: Der Haushalt 1988/89 ..... *127*
Die wichtigste Änderung, die vom Haushalt 1988/89 eingeführt wurde, ist die getrennte Veranlagung von Ehepaaren, welche vorher als einzelne Steuerzahler unter Zusammenzahlung ihrer Einkünfte besteuert wurden. Das Gesetz führte auch eine einzige Steuertabelle für alle Steuerzahler (ledig oder verheiratet) ein. Die Steuer, welcher Trusts unterliegen, wurde auch geändert, d.h. sie unterliegen jetzt derselben Steuer wie Körperschaften. Der Körperschaftsteuersatz wurde ab 50% gesenkt. Dieser Artikel beschreibt diese und sonstige Änderungen.

Lee Fook Hong:

Singapour: Nouveaux avantages fiscaux *131*
Le gouvernement de Singapour a annoncé récemment une série de nouveaux avantages fiscaux accordés en faveur des "Asian Currency Units", des gestionnaires de placements, des sociétés de titres, des revenus tirés de fonds gérés pour des investisseurs étrangers, des commerçants en hydrocarbures et des futurs contrats pétroliers et autres produits. Cet article fait ressortir les particularités de ces avantages fiscaux.

Rup Bahadur Khadka:

Népal: Résumé du système fiscal *135*
De nombreux impôts, aussi bien directs qu'indirects, ont été introduits au Népal depuis les années 50. Toutefois plus de 75% de la totalité des revenus fiscaux proviennent des impôts fondés sur les marchandises, à savoir les droits de douane, la taxe sur le chiffre d'affaires et les droits d'accise. Les impôts directs comme l'impôt sur le revenu et les taxes assises sur la propriété continuent de jouer un faible rôle dans le système fiscal népalais. L'auteur décrit l'évolution de la fiscalité népalaise et pense que les impôts directs devraient être révisés s'ils devraient atteindre les buts poursuivis par la politique fiscale.

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Lee Fook Hong:

Singapur: Neue steuerliche Förderungsmassnahmen *131*
Die singapurische Regierung hat neuerdings eine Reihe von neuen steuerlichen Förderungsmassnahmen in Aussicht gestellt. Diese Massnahmen betreffen die Asian Currency Units, Fonds Managers, Kapitalanlagegesellschaften, Einkünfte aus Fonds, die für ausländische Investoren verwaltet werden; Ölhändler und Termingeschäfte für Öl und sonstige Waren. Die Einzelheiten dieser Massnahmen werden in diesem Artikel beschrieben.

Rup Bahadur Khadka:

Nepal: ein Überblick des nepalesischen Steuersystems *135*
Seit den fünfziger Jahren sind viele Steuern – sowohl direkte als auch indirekte – in Nepal eingeführt worden. Nepal bezieht jedoch mehr als 75% seiner totalen Steuereinnahmen aus Steuern, die von Gütern erhoben werden, wie Zölle, Umsatzsteuer und Akzisen. Direkte Steuern, wie Einkommen- oder Körperschaftsteuer und Immobiliensteuern, spielen noch immer eine bescheidene Rolle im nepalesischen Steuersystem. Der Autor beschreibt die nepalesische Steuerentwicklung und ist der Auffassung, dass die direkten Steuern überholt werden müssen, wenn man sie wirklich für Steuerzwecke anwenden möchte.

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The Sixth Annual Summer Program in United States Law and Legal Institutions

17 July 1989 – 18 August 1989

The Sixth Annual Summer Program in United States Law and Legal Institutions is intended to give lawyers and advanced law students from other countries intensive exposure to the basic structure of the United States legal system and to significant areas of U.S. law. The Program should give participants both a basic understanding of the United States legal system and the U.S. legal profession and an in-depth exposure to specific areas of U.S. law that affect a broad range of commercial, investment, and personal activities. It is designed to serve as a low-cost alternative to a full-year's program in U.S. law or as a preface to advanced formal training in the United States.

The lectures of the Sixth Annual Summer Program in United States Law and Legal Institutions will be held each morning, Monday-Friday, 17 July – 18 August 1989, on the campus of the internationally-renowned University of Wisconsin, Madison, Wisconsin, U.S.A. In addition to the regular morning sessions, there will be opportunities for the participants to learn about legal research and writing and the United States legal system outside the formal lectures. The participants also will be able to meet with practicing lawyers and members of the United States judiciary. Another unique and important attraction of the Program is that participants are able to work and socialize with practicing lawyers and legal scholars from around the world.

For more detailed information regarding the program, write to:

Ms. Theresa Dougherty
University of Wisconsin
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Madison, Wisconsin 53706
U.S.A.

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UNITED STATES:

Current Issues Regarding New Financial Products*

Peter J. Connors

Mr. Connors received a Juris Doctor degree from the University of Richmond and holds a Master of Laws in Taxation from New York University School of Law. He is a Senior Manager in the Capital Markets Group at Peat Marwick Main & Co. in New York, where he specializes in matters relating to the financial services industry and international taxation.

Mr. Connors has written widely in the field of taxation with articles appearing in the *Journal of Taxation*, *Tax Management International Journal*, the *International Tax Report*, the *International Tax Journal*, and the *University of Richmond Law Review*, on a variety of subjects.

Mr. Connors is Vice Chairman of the American Bar Association's Tax Section's Committee on Financial Transactions.

I. OVERVIEW OF THE PROBLEM

The need for characterization of non-traditional investment products: are transactions properly treated as loans, or options, or sales or financing transactions?

In May the Internal Revenue Service (IRS) announced the formation of a special group to analyze the tax implications of new financial products. Subsequently, the group became part of the Financial Institutions and Products Group of the Office of Chief Counsel as part of the reorganization of that group by subject matter jurisdiction in October 1988.

This article reviews 3 issues that currently face the IRS: (1) interest rate swaps; (2) foreign currency swaps; and (3) hedging transactions following *Arkansas Best.*[1]

II. INTEREST RATE SWAPS

A. Overview

An interest rate swap is an agreement between 2 parties to exchange a series of cash flows. Typically, one party makes periodic payments based on a fixed interest rate while another party, the "counterparty", agrees to make payments based on a floating interest rate (e.g. LIBOR, commercial paper rates or Treasury bill rates). Payments are based on notional principal amounts and are usually made on a net basis at the end of an interval. Swaps often take advantage of borrowing efficiencies available to the swap counterparty.

An interest rate swap agreement can provide interest rate protection with respect to either liabilities or assets. While a borrower might use it to lock in interest expense with respect to floating rate debt, an insurance company seeking to hedge its bond portfolio could also use a swap agreement. Variations on the basic swaps involve a fixed rate recipient receiving a lump-sum payment in lieu of fixed rate payments over the life of the agreement (so-called "zero coupon swaps").

Interest rate swaps are similar to forward rate agreements. In a forward rate agreement, however, the interest rate is usually set in advance. In addition, forward rate agreements are generally for shorter time periods.

Example:

Company A, a BBB industrial with US$ 75,000,000 of floating rate liability, seeks to hedge its interest rate exposure. Company A's floating rate cost of funds is LIBOR plus ½%. Company B, an AAA financial institution, with fixed rate investor liabilities, seeks to obtain floating rate funds. Company B's fixed rate cost of funds is 11⅝%. Company A's fixed rate cost of funds absent this transaction would be 14%, while Company B's floating rate cost of funds is LIBOR plus ¼%. The parties enter into a fixed to floating interest rate swap whereby Company A receives LIBOR from Company B, while Company B receives 12½% from Company A.

The benefits of this transaction are as follows: Company A has obtained fixed rate funds at an all-in cost of 13%, whereas it could only otherwise have borrowed these funds at 14%. Company B has obtained floating rate funds at an all-in cost of LIBOR minus ⅞, which is 1⅛% lower than it could otherwise have obtained (LIBOR plus ¼) (see Exhibit 1).

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* This paper was presented at the International Tax Institute seminar held in New York in December 1988.

1. *Arkansas Best v. Commissioner*, 108 S.Ct. 971 (1988).

Outline

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B. Timing issues

1. Periodic payments

In the normal situation where interest is paid over the life of the agreement, payments will be taxable to the payee as paid or accrued. Likewise, as to the payor, they will be deductible when paid or accrued provided they qualify under Internal Revenue Code ("IRC") Sec. 162[2] as ordinary and necessary expenses.

2. Lump-sum payments – payee

The more difficult issue is how to treat lump-sum payments, i.e. should they be taxable in full, or should they be amortized? The IRS could argue that lump-sum payments are taxable when received even though they may relate to a contract with a determinable life.[3] There is a fair amount of case law suggesting that, in appropriate cases, deferral of the amount received is appropriate.[4]

3. Lump-sum payments – payor

With respect to the payor the IRS will argue that payments are to be amortized over the life of the contract.[5] This timing asymmetry creates problems for swap dealers who typically offset one position against another.

4. Deductibility of swap payments

The deductibility of swap payments must be considered in light of the straddle rules, which are discussed in detail below. At present there is a strong likelihood that swap transactions will not be considered actively traded personal property within the meaning of Sec. 1092(d)(1). If it is determined that swaps are actively traded, consideration must also be given to whether the swap can be classified as a hedge under Sec. 1256(e). In general, there will be distinctions between swaps used to hedge interest rate risk, and those used to change the nature of an instrument.

C. Character

1. Periodic payments

Swap payments do not involve a sale or exchange. Although akin in many respects to interest, they are not to be treated as interest. They do not involve a debt of the taxpayer nor do they reflect compensation for the use of money.

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2. All references are to the IRC unless otherwise indicated.
3. See *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Association v. United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957).
4. See *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976) (deferral of revenue pertaining to future engineering services); *Automated Marketing Systems, Inc. v. United States*, 74-2 U.S.T.C. § 911 (N.D. 111. 1974) (deferral of income relating to marketing services).
5. See *Lovejoy v. Commissioner*, 18 B.T.A. 1179 (1930) (commissions, service fees and printing costs to secure bank financing are to be amortized over life of financing).

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While economically similar to futures contracts, it is unlikely that interest rate swap contracts should be classified as a Sec. 1256 contract.[6] If swap contracts were treated as Sec. 1256 contracts, they would be subject to 60/40 treatment (i.e. 60% for long-term and 40% for short-term capital gain or loss), unless exempted under the hedging rules or under Sec. 1256(f)(2).

2. Character of gain or loss on disposition of swap rights

The treatment of the disposition of swap rights is unclear. As a general rule, the sale of a contract right produces capital gain. A contrary argument would take the view that the underlying transaction does not appear to be the type of property which gives rise to capital gain or loss.[7]

Ordinary income treatment would also arise if the transaction qualified for hedging treatment under the *Corn Products doctrine.*[8] The *Corn Products* doctrine was substantially narrowed in *Arkansas Best.*[9]

D. Withholding and source

The withholding issue turns on whether swap income is fixed or determinable, annual or periodical ("FDAP") income and whether it is U.S.-source. In the pure interest rate swap situation, the IRS has indicated that it would source swap income with reference to the residence of the recipient.

Advance Notice 87-4[10] sets out rules for the determination of source of income and expense attributable to cross-border contracts. The provisions of Notice 87-4 will be incorporated in Regulations to be issued with a similar effective date. The Notice only applies to interest rate swaps and only applies if the transactions involve a party which uses the U.S. dollar as its functional currency and has its residence in the United States. The Notice does not address treatment of swap premium or discount, characterization of income or expense or characterization of income from the disposition of swap contracts.

The residence restriction precludes the Notice's application to U.S. branches of foreign corporations that are otherwise subject to U.S. taxation. Query the effect of the residence rule on qualified business units of U.S. taxpayers. Are they still considered U.S.-source? Compare the distinction between transactions in the foreign branch of a U.S. company and a foreign subsidiary.

The source of swap income is determined by reference to the residence of the recipient of the income. Thus, interest rate swap payments will not be considered U.S.-source if received by a non-U.S. counterpart, unless attributable to a U.S. branch or office of the non-U.S. counterpart. Since income earned by a non-U.S. company is subject to U.S. withholding tax only if it is considered to be derived from U.S. sources, the effect of this sourcing is to eliminate the withholding issue on swap payments made by a U.S. party under a cross-border interest rate swap, without regard to whether the non-U.S. counterparty is eligible for U.S. tax treaty benefits.

The Notice adopts a sourcing rule consistent with the recent approaches in residence-based sourcing.[11] For purposes of allocation of swap expense incurred by a U.S. party in connection with an interest rate swap transaction, swap expense will be considered to have the same source as swap income receivable in connection with the transaction. U.S. persons receiving swap income will have both U.S.-source income and U.S.-source expense, with the result that net income or loss will be considered U.S.-source. A similar rule applies to swap income attributable to a U.S. trade or business of a non-U.S. counterparty. This income will be taxable in the United States and not subject to U.S. withholding tax.

Notice 87-4 applies to swap income received or accrued on or after 24 December 1986, and to swap expense, regardless of when accrued. Taxpayers are permitted to elect to apply these sourcing rules to all, but not part, of their swap income for taxable years beginning before 24 December 1986, thereby permitting taxpayers to avoid any risk that U.S. withholding tax will be imposed in respect of interest rate swap payments made to non-U.S. counterparties. The Notice, as amended, makes clear that the election is to be made by U.S. parties, not foreign counterparties (even though it relates to the "swap income" recipients).

Notice 87-4 specifically does not take a position on the classification of swap income as FDAP under Secs. 1441 or 1442 and reserves the right to characterize swap income as FDAP. The provision is apparently intended to alert U.S. taxpayers that a failure to make the election for periods before the effective date may result in the IRS applying U.S. withholding tax for interest swap payments made by a U.S. party to non-U.S. counterparties that are not protected by a U.S. tax treaty.

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6. See Sec. 1256(g)(1).
7. Compare *Miller v. Commissioner,* 37 T.C. 649 (1968) *acq.* 1968-1 C.B. 2 (assignment of lease entitled to capital gain treatment) with *Crocker v. Commissioner,* 37 T.C. 605 (1962) (sale of rights to insurance contract treated as ordinary income where proceeds represented largely accrued income).
8. *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955); see text at "V.B."
9. See also Sec. 1234A with respect to possible application to termination payments.
10. 9987-1 C.B. 411. See also Revenue Ruling 87-5, 1987-1 C.B. 180 (bank which is swap income recipient is exempt from withholding under "industrial or commercial profits" provisions of United States-Netherlands Income Tax Convention).
11. See IRC Sec. 865 (income from sale of personal property generally sourced at taxpayer's residence) and Sec. 988(a)(3) (income and loss from foreign currency gain sourced at taxpayer's residence). Note also the regulatory authority with respect to Regulations carrying out the purposes of Sec. 865 in the case of income from trading in futures contracts, forward contracts, options contracts and other instruments.

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III. CURRENCY SWAPS

A. Overview

Currency swaps also take advantage of borrowing efficiencies available to the swap counterparty. For instance, a German company can often borrow deutsche marks more cheaply than a U.S. company. Likewise, a U.S. company should be able to borrow dollars more cheaply than a German company. A currency swap permits the German company to turn its deutsche mark liability into a simulated dollar liability and the U.S. company to change its dollar liability into a simulated deutsche mark liability.

Currency swaps take several forms: (1) cross-currency fixed-to-floating rate swaps; (2) cross-currency fixed-to-fixed rate swaps; and (3) cross-currency floating-to-floating rate swaps.

In a currency swap the parties exchange 2 currencies with an agreement to re-exchange the currency at a predetermined future date. An alternative structure would call for the parties to not exchange principal at the end of the swap term; instead they agree to exchange a payment equal to the gain or loss with respect to the principal amounts involved in the swap. This form of swap in some ways resembles a forward contract.

At intervals, there will generally be an exchange of "interest" payments (although sometimes currency swaps will be structured without periodic payments). Unlike a loan, a currency swap is an off balance-sheet item.

In swaps where there is an exchange of currency at the beginning and end of the transaction, the effect is to convert assets or liabilities in one currency to an asset or borrowing in another currency.

Example:

Company A, a Swiss company, borrows 100 million Swfrs. for 5 years at 6% payable annually. As a floating rate borrower of U.S. dollars, it would pay LIBOR plus 1%. Company B, a U.S. company, borrows the dollar equivalent of 100 million Swfrs., say US$ 50 million, for 5 years at LIBOR, plus a margin of ½%. As a fixed rate borrower of Swiss francs, it would normally pay 8%. Assume $1 = 2.00 Swfrs. Companies A and B exchange the proceeds. Thereafter, each party makes payments to the other equal to the other party's underlying debt. Assume, however, that Company A does not pay the ½% margin to Company B (i.e. Company B has a "negative" spread).

At maturity, each party agrees to reverse the initial exchange: Company A exchanges $ 50 million to Company B in return for Company B exchanging 100 million Swfrs. to Company A. There will be exchange gain or loss depending on the valuation of the Swiss franc relative to the dollar at maturity.

The benefits of this transaction are as follows: Company A has obtained a U.S. dollar borrowing at LIBOR, a saving of 1% (it could only otherwise have borrowed these funds at LIBOR plus 1%). Company B has obtained a Swiss franc borrowing at 6 ½% (a rate 1½% lower than it otherwise would have been able to borrow) (see Exhibits 2.1 and 2.3).

B. Character and timing

Sec. 988 provides the treatment for foreign currency transactions after 1986. A "Sec. 988 transaction" includes futures contracts, forward contracts, option and "similar" financial instruments. The legislative history specifically speaks of swap contracts as being covered by Sec. 988. Under Sec. 988, the foreign exchange element in a Sec. 988 transaction is given ordinary income treatment. If the currency swap were marked-to-market under Sec. 1256, it would be subject to 60/40 treatment (60% long-term and 40% short-term capital gain or loss), unless the position qualified for ordinary income treatment under the hedge rules or under Sec. 1256(f)(2).

As with straight interest rate swaps, deductibility must be considered in light of the straddle rules, which are discussed in detail below. At present, there is a strong likelihood that swap transactions will not be considered actively traded personal property within the meaning of Sec. 1092(d)(1). This is more of a factor with respect to currency swaps. If it is determined that swaps are actively traded, consideration must also be given to whether the swap can be classified as a hedge under Sec. 1256(e).

Sec. 988(d) also provides for the treatment of "988 hedging transactions". Where applicable, all transactions which are part of the hedging transaction will be treated consistently. In such cases, the interim and final payments will be deductible over the life of the agreement as interest.

Where such treatment is not available, it is probably necessary to segregate both the interest and currency rate elements in a swap. The foreign currency element would qualify under Sec. 988. It is probable that the interest element would also be deductible as an ordinary item. Ordinary treatment would also be available if characterized as parallel loans. An alternative view, in cases where there is a re-exchange of currency, would defer recognition until the final exchange on the theory that the interim cash payments, based on the underlying borrowings, do not reflect any exchange rate relationship to one another.

Sec. 988(d) applies whether or not the hedging transaction is a Sec. 988 transaction. Hence, Sec. 988 can apply even if the hedging transaction would be marked-to-market under Sec. 1256. As a result, Sec. 1256(e) is largely superseded with respect to non-functional currency transactions. Importantly, the Sec. 988 hedge exception is only operative to the extent Regulations are issued. With the exception of Advance Notice 87-11, discussed below, only limited regulatory guidance is available at this time.

Prior to the 1988 amendments to Sec. 988, there was a greater likelihood that a hedge transaction would qualify for ordinary income or loss treatment if it were a swap rather than another hedging vehicle. This made the swap a better financial instrument where there was a risk that the transaction did not qualify as a hedging transaction (and thus result in capital gain or loss treatment).

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C. Withholding

The withholding issue turns on whether swap income is FDAP, and whether it is U.S.-source. As discussed above, in the pure interest rate swap situation, the IRS has indicated that it would source swap income with reference to the residence of the recipient. This means that where the counterparty is a non-U.S. person, there will be no withholding. In currency or cross interest/currency situations, the source issue is still open. Absent guidance, it is necessary to analogize to other categories of income for possible classification as FDAP and/or to structure swap agreements through treaties which have favorable withholding rules.[12]

At one point the IRS indicated that it was considering treating currency swaps that involve an exchange of principal as parallel loans. If this interpretation were adopted, withholding might again be at issue.

There is a legislative mandate in Conference Report to the Secretary for clarification of withholding tax rules for swap contracts.[13]

D. Source

Advance Notice 87-4, discussed above, specifies that the treatment of "pure" interest rate swaps is determined by the country of residence of the swap income recipient. While this ruling does not apply to currency swaps, it can be anticipated that similar rules will apply (unless the IRS characterizes these transactions as parallel loans). Moreover, where foreign currency gain or loss results, Sec. 988 provides that such gain or loss is sourced according to the residence of the party realizing such gain or loss. If the U.S. party is a net payor under a swap agreement, allocation to U.S. source might produce a more favorable result than allocation of interest would.

The source rules fore interest rate swaps must be considered in light of the requirement under Sec. 865(i) that Treasury adopt rules with respect to the sourcing for futures contracts, forward contracts, options and similar financial instruments.

E. Letter ruling 88-18010

In Private Letter Ruling 88-18010 the IRS issued its first ruling involving currency swaps. An accrual basis U.S. corporation owned stock of a foreign corporation. In order to hedge against losses in value of the stock resulting from exchange rate movements between the foreign currency and the dollar, the taxpayer entered into 3 currency swap agreements with 2 other U.S. corporations in 1985. Under each agreement, a series of 6 currency swaps were to be made with the taxpayer receiving dollars and paying in foreign currency.

There was no exchange of a principal amount at the inception of the currency swap agreements in 1985. The rate of exchange used to compute the various payments under the agreements was a spot rate on the day the transactions were entered into. The notional interest payments reflected the foreign currency and the dollar borrowing rates for certain debt instruments with 5-year maturities in effect on the day the agreements were entered into.

As a result of the weakening of the dollar, the taxpayer incurred a substantial economic loss on its position in the currency swap agreements. The taxpayer planned to limit its exposure by entering into offsetting reverse swap agreements with the same 2 corporations. The taxpayer was to pay dollars and receive foreign currency on specified payment dates in 1988, 1989 and 1990. The future effects of the reverse swaps (assuming no changed circumstances) would be that, on each notional interest payment, the taxpayer will have a certain net unhedged exposure and will incur a loss on the hedged amount. The taxpayer would incur a loss with respect to the notional principal.

The IRS considered 4 issues in this ruling:

1. Application of Sec. 1256

First, the IRS ruled that the currency swap agreements were *not* Sec. 1256 contracts. Looking at the legislative history of Sec. 1256, the IRS concluded that Congress intended to include bank forward contracts within the definition of foreign currency contracts. The IRS determined that currency swap contracts are significantly different to bank forward contracts in the way interest rate differentials in the currencies that are the subject of the contracts are accounted for. Accordingly, the IRS found that the term "foreign currency contracts", as used in Sec. 1256 did not include the currency swaps under consideration.

2. Treatment under Sec. 988(c)

The IRS next ruled that the currency swaps in issue were "similar financial instruments" within the meaning of Sec. 988(c)(1)(B)(iii).

3. Transitional rule status

The IRS then ruled that Sec. 988 applied to payments made pursuant to the swap agreements in taxable years beginning after 31 December 1986, even though the agreements had been entered into prior to 1986.

4. Treatment of swap reversals

Fourth, the IRS held that entering into the reverse swap position was not an event that falls within the meaning of the "payment date" as defined in Sec. 988(c)(3)(B). Thus, although the IRS agreed with the taxpayer on the application of Sec. 988 to these currency swap and reverse swap agreements, the IRS said that the enactment of Sec. 988 did not generally change the timing of exchange gain or loss on a Sec. 988

12. See United States–United Kingdom Income Tax Convention, Art. 22 (no tax on items not specified unless effectively connected with a trade or business in the other country); see also Revenue Ruling 87-5, footnote 10.
13. Conference Committee Staff, *The Tax Reform Act of 1986: Conference Report to Accompany H.R. 3838* at II-668 (Comm. Print 1986).

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transaction as determined under prior law. This analysis may indicate that the IRS views the transaction as a property transaction. As a property transaction, there should be no FDAP.

F. Advance Notice 87-11

In advance of the issuance of Regulations, Advance Notice 87-11[14] provides for the integrated treatment of fully hedged currency transactions ("qualified hedging transactions") that are "integrated economic packages" and are entered into after 31 December 1986 in taxable years beginning after 31 December 1986 and that meet the following conditions (among others):

(1) The hedged transaction (a "qualifying transaction") is a borrowing under, or a purchase of, a debt instrument which is entirely denominated (principal and interest) in a single currency.

(2) The hedge (a "Sec. 988 hedge") is a currency swap (or forward contract or spot contract) which fixes the cost or return with respect to the qualifying transaction in terms of a currency other than the currency in which the transaction is denominated such that such cost or return is not affected by exchange rate movements after the "trade date".

(3) The interest rate on the qualifying transaction and all exchange rates on the hedge are fixed on the same calendar date (the "trade date").

(4) All transactions that comprise the qualified hedging transaction are entered into on or before the calendar day (the "settlement date") on which the borrowed proceeds under a hedged borrowing, or the debt instrument under a hedged purchase, are made available.

(5) The qualifying transaction matures on the same trade date the hedge expires.

(6) None of the parties to the qualifying transaction or the hedge are related.

(7) The hedge assures that appropriate currency amounts are payable on the same calendar day that amounts (e.g. initial proceeds, interest and principal) are payable under the qualifying transaction.

(8) The hedge and the related qualifying transaction are identified before the close of the trade date on the taxpayer's records as being part of the qualified hedging transaction.

(9) The Notice does not affect the obligation of any person to withhold under Secs. 1441 and 1442.

Where the transaction constitutes a qualifying hedging transaction, then the qualified transaction and the hedge are integrated and treated as a single transaction. If it were a qualifying hedging transaction, in the transaction described in the Example in Part III.A. above, Company B's U.S. dollar borrowing would be treated as a Swiss franc borrowing with Swiss franc (in U.S. dollar equivalents) interest payments. Gain or loss would not be recognized separately with respect to the currency swap.

IV. OTHER INTERNATIONAL ISSUES

A. Foreign tax credit issues

Source is to be determined as above. In connection with the determination of the foreign tax credit baskets, swap income is treated as financial services income for a financial services entity under IRC Regulation (Reg.) §1.904-6(e)(2)(i)(L). For taxpayers not engaged in a banking, financing or similar business, it will be necessary to determine whether the swap income would otherwise be Subpart F income. There may be a distinction between pure interest rate swaps and swaps involving foreign currency gain.

B. Treatment under interest allocation Regulations

Although the Regulations address instances in which expenses will be viewed as interest equivalents, the Regulations do not specifically treat swap payments as interest or interest equivalents.[15] Additionally, swap transactions do not appear to fit within the limited category of "integrated financial transactions".[16]

C. Treatment under Subpart F

Subpart F treatment will vary depending on whether the swaps are pure interest rate swaps, currency swaps or cross currency/interest rate swaps.

1. Interest rate swaps

There are 3 provisions in Sec. 954(c)(1) under which the IRS might assert that "pure interest rate" swaps constitute Subpart F income. These are: (i) Sec. 954(c)(1)(A), which includes interest; (ii) Sec. 954(c)(1)(C), relating to transactions in commodities; and (iii) Sec. 954(c)(1)(E), relating to interest equivalent transactions.

(a) *Possible treatment as interest*

Swap income should not be treated as interest, which, for Federal income tax purposes, is compensation for the use or forbearance of use of money.[17] Although not specifically characterizing swap income as compensation for the use of money, the Temporary Regulations do specifically provide that swap income is not included in the category income equivalent to interest.[18]

(b) *Possible treatment as commodity transaction*

Swap income should not be treated as "similar" to a commodity transaction as there is no indication under prior or present law that swap transactions are to be

14. 1987-1 C.B. 423.
15. Temp. Reg. §1.861-9T(b).
16. Temp. Reg. §1.861-10T(c).
17. See *Deputy v. Dupont*, 308 U.S. 488, 498 (1940); Rev. Rul. 87-5, 1987-1 C.B. 180, discussed above.
18. Temp. Reg. §1.954-2T(i).

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treated as similar to futures and forward transactions in commodities. That is, while "futures, forward and similar transactions" in commodities are taxed under Subpart F, there is no indication in the context of Sec. 954(c) as to the scope of the phrase "similar position".

The Temporary Regulations define a commodity as being tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and non-functional foreign currencies.[19] A commodity transaction is defined essentially as any purchase or sale of a commodity.[20] Thus, a foreign currency swap would appear to be covered by the commodity transaction rules.

(c) *Treatment as equivalent to interest*

Legislative history regarding Sec. 954(c)(1)(E) addresses a concern that: "[I]nventive taxpayers are continuing to develop and use new economic substitutes for loans in an attempt to manipulate the Subpart F rules and the foreign tax credit. Income equivalent to interest is nothing more, and nothing less, than income from such new and developing types of financing transactions which attempt to disguise in some other form income that is attributable to the *time value of money*." (emphasis added)[21]

The Temporary Regulations now provide that swap income *does not* constitute income equivalent to interest unless the income is derived as "part of an integrated transaction that gives rise to income equivalent to interest".[22] The Regulation goes on to say that if a swap dealer is "acting in its capacity as a regular dealer in such contracts" it is presumed not to have entered into an integrated transaction.

2. Swaps involving foreign currency

To the extent a swap transaction involves foreign currency gain, Sec. 954(c)(1)(D) is relevant. This treats as Subpart F income "the excess of foreign currency gains over foreign currency losses attributable to any sections 988 transactions". The foreign exchange element of a swap transaction is subject to this provision as swap transactions are treated as "Sec. 988 transactions", which are specifically included in this provision.[23]

As noted above, currency swaps would also appear to meet the definition of commodities transactions; the ordering rules of the Temporary Regulations indicate that if a transaction falls within both the foreign currency and commodity category, the foreign currency category will govern.[24] Exceptions are available for qualified business and qualified hedging transactions.[25] Foreign currency gain or loss, for these purposes, is computed with reference to the functional currency of the unit.

V. *ARKANSAS BEST* ISSUES

A. Background

The hedge election under Sec. 1256(e) must be read in light of Sec. 1092, which requires that loss in connection with certain straddles be deferred.

Sec. 1092(c)(1) defines a straddle to mean an "offsetting position" with respect to personal property. The loss deferral rules prevent the recognition of loss realized on one or more "positions" of a straddle to the extent of gains in other positions of the straddle are not yet realized by the end of the taxable year.[26] "Offsetting positions" are present if holding a position in personal property substantially diminishes a taxpayer's risk in holding the positions in personal property.[27]

Certain presumptions apply as to what will and will not be treated as an offsetting position.[28] The Secretary has indicated by Temporary Regulations that positions are offsetting if a "reasonable person" would expect them to be on the basis of all the facts and circumstances.[29]

A "position" is any interest in personal property.[30] Positions held by one's spouse, by an affiliated corporation in a consolidated return, or by a "flow-through entity" (such as a partnership or trust) whose gain or loss is at least partly accounted for by the taxpayer, are treated as held by the taxpayer.[31] Personal property is any personal property of a type which is actively traded[32] and includes positions which are actively traded, even if the underlying personal property is not actively traded.

A taxpayer's debt should not constitute personal property, whereas an interest in a debt obligation of another should qualify. A taxpayer's obligation which is denominated in foreign currency should be considered personal property.[33]

Any loss which is not allowed is carried over and treated as incurred in the following year unless again disallowed under the general loss deferral rule. The loss which is disallowed is "a loss otherwise allowable under Sec. 165(a)".[34] To the extent payments that are made are deductible under Sec. 162, Sec. 1092 should not apply. Sec. 1092 does not apply to certain "hedging transactions".

19. Temp. Reg. §1.954-2T(f)(2)(i).
20. Temp. Reg. §1.954-2T(f)(2)(ii).
21. 128 Cong. Rec. H 8359 (25 September 1986); see also 134 Cong. Rec. E 3389 (2 October 1986), where the "time value of money" concept is emphasized.
22. Temp. Reg. §1.954-2T(h)(i).
23. Temp. Reg. §1.954-2T(g)(1).
24. Temp. Reg. §1.954-2T(a)(2).
25. Temp. Reg. §1.954-2T(g)(3) and (4).
26. Sec. 1092(a)(1)(A).
27. Sec. 1092(a)(2)(A).
28. Sec. 1092(c)(3).
29. Temp. Reg. §1.1092(b)-4T(b)(4), Example.
30. Sec. 1092(d)(2).
31. Secs. 1092(d)(4) and 7701(f).
32. Sec. 1092(d)(1).
33. Sec. 1092(d)(7), as added by the 1986 Tax Act.
34. Temp. Reg. §1.1092(b)-5T(d).

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B. Capitalizing straddle carrying costs

Interest and carrying charges on personal property that is part of a straddle are not allowed as a current deduction but must be capitalized and deducted when the subject property is disposed of.[35] The disallowed amount is the excess of such charges over interest earned (including OID), any amount treated as ordinary income under Secs. 1271(a)(3)(A), 1278 and 1281(a) and the excess of any dividends includible in gross income.[36]

The charges in question include interest on debt incurred or continued to purchase or carry the personal property.[37] They also include charges to carry the property in a short sale, for storage, insurance, transportation and the like.[38] Charges incurred in a hedging transaction, however, as defined under Sec. 1256(e), are exempt from the capitalization rule.[39]

C. The problem: fitting within the Sec. 1256(e) exception

Under Sec. 1256(e)(2) a transaction will qualify as a hedging transaction if it meets all of the following requirements: (1) the purpose of the transaction must be to reduce the risk of (i) price changes or currency fluctuation with respect to property which is held or to be held by the taxpayer, or (ii) interest rate or price changes or currency fluctuations with respect to borrowing made or to be made or obligations incurred or to be incurred, by the taxpayer; (2) gain or loss on the transactions must be treated as ordinary income or loss; and (3) before the close of the day on which such transaction was entered into (or such earlier time as the Secretary may prescribe by Regulations), the taxpayer must clearly identify such transaction as being a hedging transaction.

1. Primary purpose test

The purpose of the transaction must be primarily to reduce the risk of (i) price change or currency fluctuation with respect to property which is held or to be held by the taxpayer; or (ii) interest rate or price changes or currency fluctuations with respect to borrowing made or to be made or obligations incurred or to be incurred by the taxpayer.[40]

The principal impact of this provision is that the transaction may not be speculative. Prior to the 1986 Tax Act, this provision did not apply to banks, thereby enabling them to engage in transactions which did not include risk reduction. The application of this provision is unclear where the transaction serves to change the nature of an asset or liability (from a floating rate or fixed rate). For instance, changing a floating rate liability to fixed rate serves to lock in a taxpayer's interest cost, thereby protecting the taxpayer in the event interest rates go up. In contrast, changing a fixed rate liability to floating rate serves to give the taxpayer the benefit of rate declines. The latter transaction would appear not to qualify for hedge treatment.

2. Ordinary income test

Gain or loss on the transaction must be ordinary. The question that arises in whether gain from the hedging transaction or the underlying transaction must be ordinary, and whether all gain or the predominant portion of income associated with the position must be ordinary.

(a) *Language of Sec. 1256(e)*

Sec. 1256(e) provides in part that a transaction will qualify as a hedging transaction if "the gain or loss on *such transactions* is treated as ordinary income or loss". The term "such transactions" as used in that provision seems literally to refer to the gain or loss from the hedge, such as the gain or loss incurred on the disposition of a foreign currency contract, rather than to the gain or loss that would be derived from the disposition of the underlying hedged property.

The IRS has, however, also interpreted this requirement to mean that both transactions must receive ordinary income treatment, that is, the hedge and the underlying property.[41] Under this reading, asset hedges will qualify for Sec. 1256 treatment in only limited instances.

(b) *Application problems*

Application of this test is unclear in instances where the property being hedged normally produces ordinary income or loss, but could produce capital gain on a sale. Should the dominant method of fulfilling the obligation govern?

3. Identification requirement

Before the close of the day on which the hedge was entered into (or such earlier time as the Secretary may prescribe by Regulations), the taxpayer must clearly identify such transaction as being a hedging transaction. Designating the transaction on the taxpayer's books and records should qualify, in the absence of a more specific regulatory requirement.[42]

Once identified as a hedge, pursuant to Sec. 1256(f)(1), gain can never be treated by the taxpayer as capital gain.

4. Hedging investments in foreign subsidiaries

In *The Hoover Company*[43] a U.S. parent corporation entered into a series of foreign currency contracts to hedge the value of its investment in its U.K. subsidiary

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35. Sec. 263(g)(1).
36. Sec. 263(g)(2)(B).
37. Sec. 263(g)(2)(A)(i).
38. Sec. 263(2)(ii).
39. Sec. 263(g)(3).
40. Sec. 1256(e)(2)(A).
41. See General Explanation to the Tax Act of 1981 at 299.
42. Cf. Temp. Reg. §1.1092-3T(d) (in connection with the application of the identified mixed straddle election, taxpayer's transaction must be susceptible by independent verification).
43. 72 T.C. 206 (1979).

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for financial reporting purposes. During the years in issue, the taxpayer incurred a loss upon the disposition of the foreign currency contracts and the taxpayer treated the loss as an ordinary loss. The IRS argued that the loss incurred upon the disposition of the forward exchange contracts was a capital loss because the foreign currency contracts were not acquired to hedge an ordinary income item. The court agreed with the IRS.

If the court's reasoning in *Hoover* is used to interpret the hedging exception in Sec. 1256(e), which includes the requirement that the gain or loss on the transaction must be ordinary, the hedging exception will not be available when a foreign currency contract is used to offset the fluctuation of the dollar value of an investment in a foreign subsidiary (see below, however, regarding the Moynihan/Dole colloquy) since the character of the hedge will be determined by the underlying asset.

(a) *Moynihan/Dole colloquy*

The difficulty in applying the hedging exception to certain asset hedges is further highlighted by a key colloquy between Senators Moynihan and Dole during the 1981 Senate floor debate on certain ultimately enacted technical amendments to the original bill language of Sec. 1256(f)(1). Sec 1256(f)(1) denies capital gain on property which was part of a hedge. The amendment to that section inserted the word "personal" before property and inserted the parenthetical "(as defined in Sec. 1092(d)(1))" after property, thus limiting application of the provision. According to the Moynihan/Dole colloquy, the purpose of the technical amendments to the original version of Sec. 1256(f)(1) was to allow corporations to hedge the foreign exchange risk associated with owning "Sec. 1248 stock" and Sec. 1231(b) assets, without changing the capital gains treatment of that stock or those assets in later years. Thus, the colloquy was designed to cover the *Hoover* hedge situation.

(b) *Legislative history*

On the other hand, the ERTA Committee Reports suggest that the determination of whether particular gains or losses from foreign currency contracts may be treated as ordinary for Sec. 1256 purposes ultimately depends upon whether the gains or losses from the underlying property being hedged may be treated as ordinary; in other words, the Committee reports appear to adopt the look-through approach of *Hoover* to determine whether the gain or loss on the hedge should be treated as ordinary.[44]

(c) *Impact on Hoover hedges*

The literal language of Sec. 1256(f)(1) and the Moynihan/Dole colloquy suggest that the gain from a foreign currency contract acquired to hedge the taxpayer's investment in a foreign subsidiary may be ordinary, even though the gain upon the disposition of the underlying property may be capital. Under this reading, such a transaction may qualify as a Sec. 1256(e) hedge.

D. Interplay between Sec. 1256(e) and (f)

As noted above, Sec. 1256(f)(1) provides that "*gain* from any personal property (as defined in Sec. 1092(d)(1)) shall in no event be considered as gain from the sale or exchange of a capital asset" if the property was identified as a hedge under Sec. 1256(e). One way of interpreting this language is that if the foreign currency contract is identified as part of a hedge, then the gain on the forward contract shall be treated as ordinary even if the gain or loss recognized upon the disposition of the underlying hedged asset is a capital gain or loss. This interpretation is consistent with the statement in the legislative history that "[i]f property has been identified by the taxpayer as being part of a hedging transaction, gain from the sale or exchange of the property may never be treated as capital gain, but must be reported as ordinary income".[45] For example, the taxpayer could not claim that following the disposition of the underlying transaction, the hedge was held for investment purposes, thereby qualifying for capital gain.

E. The ordinary income requirement and *Arkansas Best*

1. Background

In *Arkansas Best* the U.S. Supreme Court adopted a very strict reading of Sec. 1221 and determined that the motive (business or investment) for acquiring property is irrelevant in determining whether an asset is a capital asset within the meaning of Sec. 1221. Thus, *Arkansas Best* severely cut back the *Corn Products* doctrine which treated an asset as being ordinary in nature if it was integrally related to the taxpayer's trade or business (i.e. acquired with a business motive). Prior to *Arkansas Best,* if the hedge was entered into as an integral part of the taxpayer's trade or business, it was felt that the ordinary income requirement would be met. Because Sec. 1256(e) is viewed as the statutory ratification of the *Corn Products* doctrine, in effect, *Arkansas Best* seems to overrule portions of Sec. 1256(e).

2. Subsequent cases

In *Barnes Group Inc. v. United States*[46] the taxpayer sold a foreign currency future to protect itself from a loss caused by a potential devaluation of the Swedish krona. The taxpayer considered the loss as ordinary, since the transaction was entered into to offset possible paper losses that would have received ordinary loss treatment. However, in the absence of the taxpayer arguing that its subjective intent was to utilize the foreign currency exchange as a "surrogate" for an asset exempt from capital treatment, it held that the incurred loss was capital in nature because it failed to meet any of the listed statutory exemptions in Sec. 1221.

44. ERTA Senate Report at 200.
45. ERTA Senate Report at 160.
46. 88-2 U.S.T.C. 9503 (D. Conn. 1988).

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The court indicated that *Hoover* must be reexamined in light of *Arkansas Best.*

3. Whipsaw effect

Arkansas Best potentially produces a whipsaw effect on transactions which were identified as hedges. Under Sec. 1256(f)(1), gain on property identified as a hedge will always be ordinary; any loss, however, would arguably be capital (assuming it could no longer receive ordinary income treatment under *Corn Products,* as modified by *Arkansas Best*), even though the transaction was improperly identified as a hedge. This result is potentially applicable to all open tax years.

F. Hedging a foreign currency debt

1. Sec. 1092

If a foreign currency contract is used to hedge a foreign currency borrowing, a straddle exists and Sec. 1092 applies. The forward exchange contract and the loan payable are offsetting positions in personal property (the loan is, in essence, a short position in foreign currency).

2. Sec. 1256

Sec. 1256(a) will apply to a forward exchange contract (provided it involves a currency in which positions are traded through regulated futures contracts) acquired to hedge a foreign currency loan. As discussed below, gain or loss on the forward will no longer be treated as capital gain. Because of the ordinary income status of the forward contract, the hedge will now qualify under Sec. 1256(e).

G. Sec. 988(c)(1)(D)(ii)

The 1988 Tax Act eliminated the disparity between foreign currency contracts traded through futures contracts and those not so traded with the enactment of Sec. 988(c)(1)(B)(iii). Positions entered into after 21 October 1988 are treated as being subject to ordinary income treatment for both source and character purposes. Contracts that would otherwise be marked-to-market under Sec. 1256 continue to be subject to those rules, although now as ordinary income. The 1988 Tax Act did not change the treatment of futures contracts and options ("Sec. 988(c)(1)(D)(i) contracts") in foreign currency; instead, to be treated under Sec. 988, an election must be made on the first day of the taxable year in which those positions are held. The carve-out for futures and options was a reaction to the concerns of traders, who had a preference for capital gain treatment. An earlier version of the rule would have made ordinary income treatment the standard, with an available election for capital gain treatment.

1. Advance Notice 88-124

On 2 December 1988 in Notice 88-124[47] the IRS issued guidelines concerning the manner in which such election is to be made. Importantly, the Notice indicates that to be effective for 1988 the election must be made by 31 December 1988. For 1989 and later years the election is to be made by the first day in which either a foreign currency future or option is held.

2. Form of the election

The election should contain the following information: (1) the taxpayer's name, address and identifying number; (2) the date the notice is mailed or otherwise delivered to the IRS Center; (3) a statement that the taxpayer and all members of its affiliated group elect to have Sec. 988(c)(1)(D)(i) not apply; (4) the date of the beginning of the tax year for which the election applies; (5) if the election is filed after the first day of the taxable year, then a statement as to whether the taxpayer previously held a contract described in Sec. 988(c)(1)(D)(i), and the first day on which such contract was held; and (6) the signature of the party making the election.[48]

3. Effect of the election

The effect of the election is to treat gain or loss from all futures and options held in foreign currency that would otherwise be subject to Sec. 1256, as subject to Sec. 988 for source and character purposes. An election will also be binding on any income or loss derived from all contracts described in Sec. 988(c)(1)(D)(i), in which the taxpayer holds a direct or indirect interest.

4. Effect of late election

Notice 88-124 contemplates that taxpayers may in some instances make late election. If the election is made within 30 days of the time otherwise prescribed for making the election, the election will be effective as of the beginning of the taxable year. However, losses recognized during the taxable year on positions which were held on or before the date of the election will not be treated as Sec. 988 losses. The principal effect, then, is that losses will most probably be treated as 60% long-term and 40% short-term capital gain.[49]

5. Revoking an election

Elections made under this provision may be only revoked with the consent of the Commissioner. Notice 88-124 states that in determining whether to grant a revocation "recapture of the tax benefit derived from making the election in previous years will be considered". This would include, for example, the deduc-

47. Notice 88-124, 1988-51 I.R.B. 1.
48. The election is to be filed with the IRS Center in Kansas City, Missouri.
49. Although not entirely clear, it appears that an election may be made in years following the period in which the position is acquired and still be effective, provided it is made within the timeframe specified. "[A]n election under section 988(c)(1)(D)(ii) for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such year on which the taxpayer holds contract described in section 988(c)(1)(D)(i)." Notice 88-124, Section 1. B. For example, if the election is made on 29 December for the following year, it should still qualify, even though contracts were held during the year or preceding years so long as the election is made by 1 January "of such year." This would make sense, so long as the position was marked-to-market at the end of the year preceding the election.

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tion of ordinary losses that would have been nondeductible if the positions had been subject to capital treatment.

6. Considerations in making the election

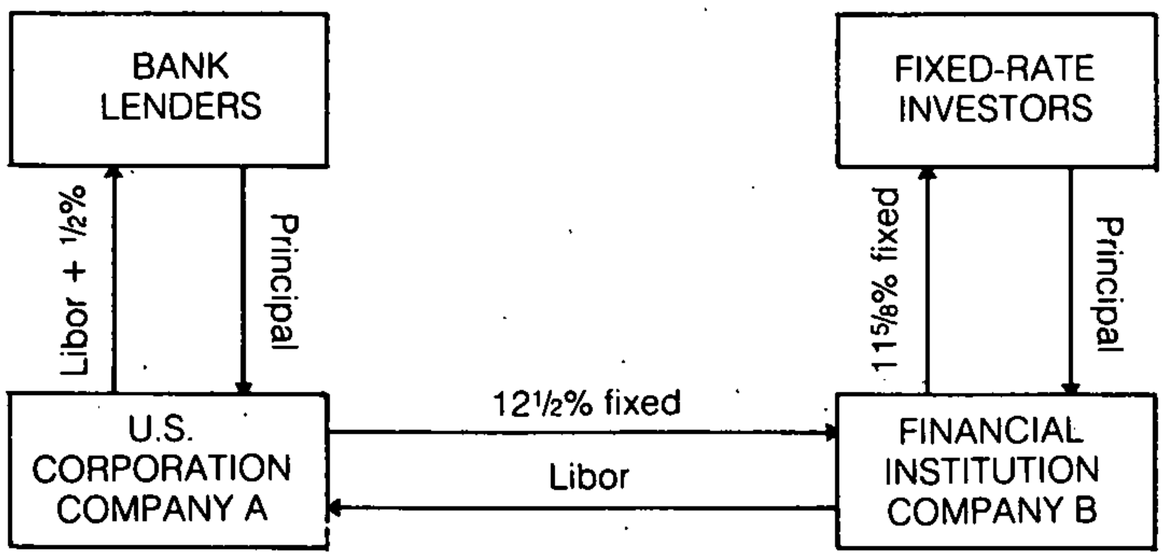
The principal consideration involved in making the election will be whether the taxpayer receives an advantage by obtaining ordinary income treatment from foreign currency futures and options. Under present law, there is no rate differential between capital income and ordinary income; however, for corporate taxpayers, capital losses can generally only be deducted to the extent of capital gains (although carrybacks and carryovers are available). Thus, under present law there is no advantage in receiving capital gains treatment, unless the taxpayer has prior or anticipated capital losses. In considering the election, however, taxpayers other than corporations should be aware of Sec. 1212(c), which permits the carryback of losses from Sec. 1256 contracts (carrybacks of capital losses are generally not available for individuals).

7. Impact on hedging election

The other major consideration in making the Sec. 988(c)(1)(D)(ii) election is whether, by making the election, application of the *Arkansas Best* decision can be avoided. Since making the election permits taxpayers to satisfy the requirement under Sec. 1256(e)(2)(B) that all aspects of both the underlying transaction and the hedge receive ordinary income treatment, taxpayers making the election who use these contracts to hedge foreign currency exposure can now make the Sec. 1256(e) election and thus be certain to avoid application of both the marked-to-market and the straddle rules. The election will not, however, eliminate any exposure for positions which were acquired prior to 22 October 1988 and which are otherwise within the application of the *Arkansas Best* decision.

Exhibit 1

Floating to fixed interest rate swap



Company A: All-in cost: 13% (12½ + ½)

Company B: All-in cost: Libor – ⅞% (Libor +11⅝ – 12½)

Exhibit 2.1

Currency swap
Initial exchange

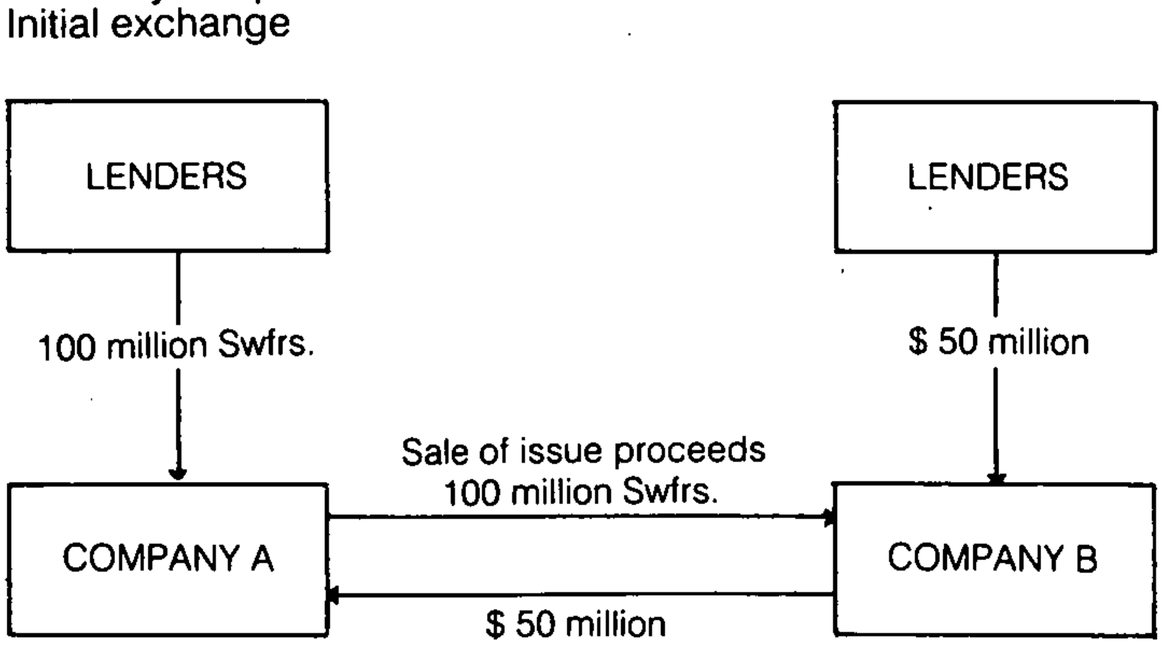
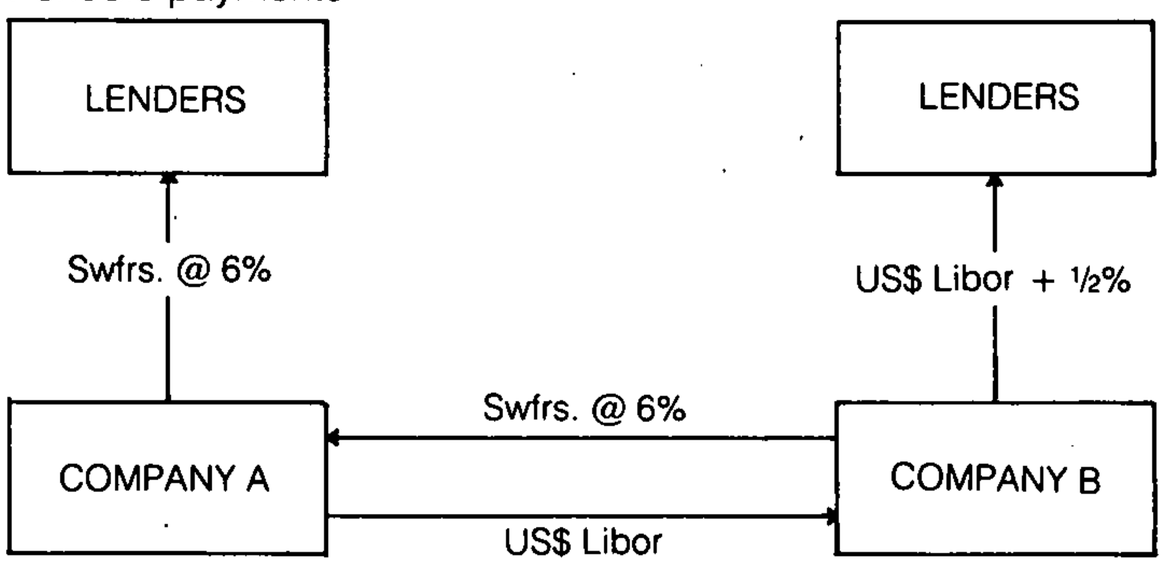


Exhibit 2.2

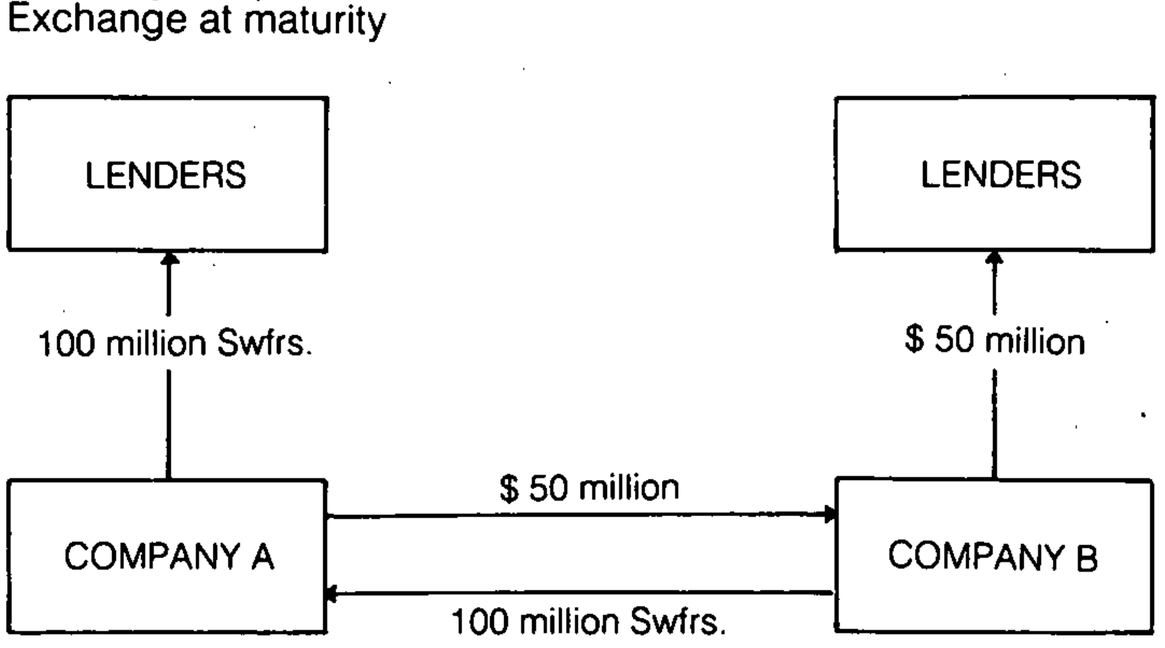
Currency swap
Periodic payments



Company A: All-in cost: Libor (6%-6%)
Company B: All-in cost: 6 + ½% (Libor-Libor, plus ½%)

Exhibit 2.3

Currency swap
Exchange at maturity



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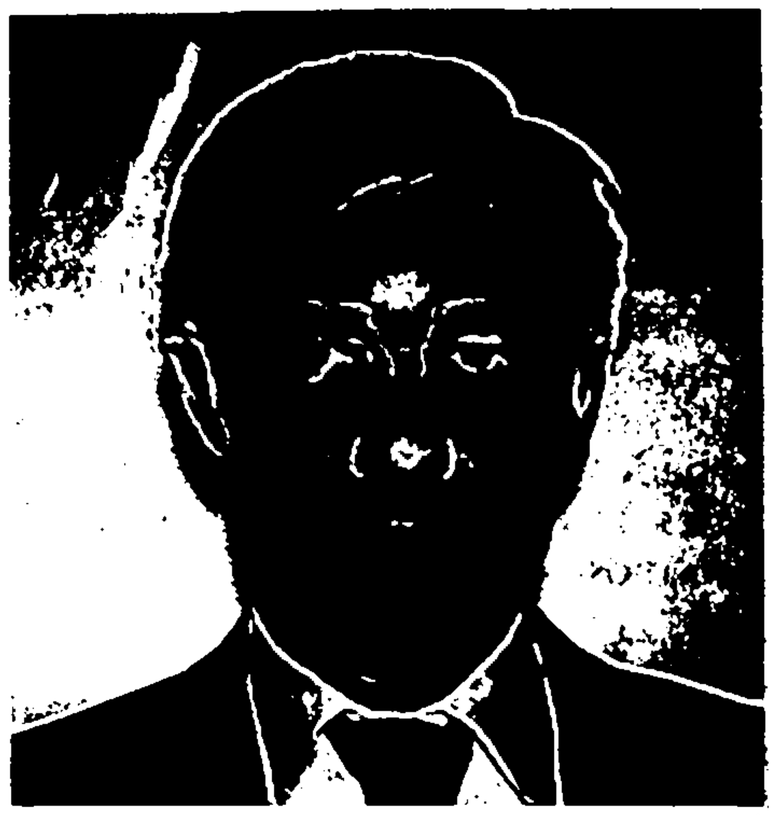
The Caribbean Basin Tax Information Exchange Agreements Program of the United States:
Eat Softly and Carry a Big Stick

Bruce Zagaris



Bruce Zagaris:
Berliner & Maloney, Washington, D.C.; chair, Committee on Caribbean Law, Section of International Law & Practice, American Bar Association, 1981-86; chair, Committee on International Tax Law, Sec. of Int'l Law, ABA, 1987- ; chair, Committee on Criminal Law & Procedure, Inter-American Bar Association, 1985- ; representative, Association Internationale de Droit Pénal to the O.A.S., 1985 - ; agent, Government of Barbados; lecturer at law, University of the West Indies, 1977-78; consultant, U.S.A.I.D., Administration of Justice for the Commonwealth Caribbean Project, 1986. The remarks in this article are neither made on behalf of nor approved by any of these organizations.

I. INTRODUCTION

The title of this paper has an appetizingly historical connotation. The Caribbean policy of the Teddy Roosevelt Administration was characterized by the phrase: "speak softly and carry a big stick".[1] The Tax Information Exchange Agreements ("TIEA") program of the Caribbean Basin Initiative ("CBI") can be characterized as "eat softly and carry a big stick". The latter characterization appropriately indicates the problem of too few incentives, often referred to as carrots, and hence, the "eat softly", while the "big stick" refers to the problem of too many ways to force the Caribbean to behave or conform to what U.S. policymakers want and the enactment of legislation to punish them; hence, the term "the big stick".

This discussion concerns the status of the tax information exchange agreement program of the United States.[2] The discussion will build on my earlier comments of the TIEA program in August 1985 and February 1986.[3] In particular, the evaluation today has not changed essentially. The status of the program remains that, although 3 more countries and a total of 5 countries out of 29 are eligible as signatories and for the incentives received by signatories, the bulk of the CBI beneficiary Governments do not want to sign. At a time when Congress has mandated that the U.S. Government conclude additional exchange of information agreements with countries with offshore financial centers and penalize those that do not conclude such agreements, a further assessment of the TIEA program is useful.[4]

Most importantly, President Reagan correctly believed that without real incentives no substantial investment from the U.S. private sector would occur in the Caribbean. President Reagan's proposal was for investment tax credits. Instead, Congress provided to TIEA signatories eligibility for: convention deductions; foreign sales corporations (FSCs); and Sec. 936 financing. The problem with the TIEA program remains that, since it is a unilateral program, it offers too little and asks too much.

II. KEEPING ITS WORD

Before I address the need to improve the incentives, a paramount consideration is that, once the United States makes a deal, it must keep it. Too often, the problem with the CBI is that, while the law excludes most products, the rhetoric has been that many opportunities await the Caribbean businesses. The few times businesses and governments take advantage of a potential opportunity to export something to the United States, they run into a new obstacle – whether it be ethanol, orange juice, parakeets, and most recently captive insurance companies. The latter example of insurance companies is especially important.

1. For background on the Caribbean policy of Theodore Roosevelt, see Langley, *The United States and the Caribbean in the Twentieth Century* (Ch. 1, Theodore Roosevelt and the Big Stick) (1982) at 17-43; Martin, *U.S. Policy in the Caribbean* (1978) at 17-20; Bemis, *The Latin-American Policy of the United States* (1943) at 142-67.
2. The provisions for tax information exchange agreements as part of the Caribbean Basin Economic Recovery Act are contained in new Internal Revenue Code, Subsec. 274(h)(6).
3. Zagaris, B., "The Caribbean Basin Initiative", *Tax Notes* (26 August 1985) at 1021; Zagaris and Papavizas, Statement, "Review of the Impact and Effectiveness of the Caribbean Initiative" (Hearings Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives (25-27 February 1986) at 476-97.
4. For a discussion of the requirement that Treasury conclude information exchange agreements relating to money laundering, see Sec. 1363 of the Anti-Drug Abuse Act of 1986 and Sec. 4702 of the Anti-Drug Abuse Act of 1988.

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In May 1983, the United State precipitously cancelled the tax treaty with Barbados.[5] Barbados spent substantial resources in a short period of time and, after 4 or 5 negotiations, reached an agreement in 1984, signing simultaneously both the tax treaty and the first TIEA under the CBI.[6] It was the only government to sign a TIEA for the first couple of years. The U.S.–Barbados income tax treaty contained an exemption for premium insurance excise tax. The exemption allowed Barbados to attract approximately 140 U.S. companies to establish offshore insurance companies in Barbados.[7]

Within 3 months of ratification in 1986, after the U.S. insurance industry and later a competitor of Barbados, Bermuda, complained, members of Congress began calling for the termination of the Barbados treaty or legislation to override the insurance excise tax provisions.[8]

When the United States communicated to Barbados its desire to discuss the exemption, Barbados agreed even though the treaty did not allow the United States to give notice that it wanted to terminate some or all of the treaty until June 1989. Even then, the termination notice could not take effect until January 1990. However, notwithstanding the treaty, on 12 October 1988, Senator Metzenbaum introduced an amendment to the new tax act that was adopted and passed, without objection from the Reagan Administration, on 22 October.[9] This amendment taxes those premiums paid in 1989 that are for 1990 coverage – a clear breach of the treaty. The breach follows other overrides by Congress of its tax treaties, one example most recently being the branch profits tax.[10] The lesson from the Metzenbaum amendment is that, even if you have an agreement with the United States it may last only as long as Congress deems it useful. Unless Congress changes its behavior, the question will become, whether any agreement is worth our discussion or more importantly worth any capital investment.

III. ENHANCING INCENTIVES

What is needed is not convention deductions, nor FSCs nor Sec. 936. Even taken together, they still do not amount to an interest of most Caribbean Governments. Although the U.S. Government, Puerto Rico and the CBI beneficiary Governments should try to improve the Sec. 936 program, they should not do so with the misperception that it will lead, for example, the Bahamas, the Cayman Islands, or Belize to conclude TIEAs.

Just as importantly, the perception in the Caribbean that the United States wants these recently independent Governments to compromise their sovereignty by overriding their laws makes TIEAs politically unpalatable.[11] No matter how much money is to be gained or how severe U.S. threats to punish what it believes are recalcitrant Governments and leaders, a Caribbean leader or country that cannot maintain its integrity and sovereignty is not independent. If the United States pushes too hard on its enforcement program, it may backfire.

The first order of business is that incentive must be strengthened. One approach of most industrialized Governments, including Canada in its own Caribbean initiative program known as CARIBCAN, is to negotiate full-fledged tax treaties.[12] Experience shows that foreign investment is attracted by confidentiality of investments – a goal inimical to the TIEAs. Tax treaties will help U.S. investors to avoid double taxation and obtain reduced withholding rates on dividends, interest and royalties. Many potential incentives can be offered to interest CBI beneficiaries into concluding TIEAs. In my testimony in Congress in 1986, I outlined a few:

– The U.S. should provide technical assistance in tax administration to CBI countries requesting it. This

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5. For a background on the prior U.S. Barbados treaty and its termination, see Rhoades and Langer, 4 *Income Taxation of Foreign Related Transactions*, Chapter 78X.

6. For a discussion of the linkage between the income tax treaty and the TIEA, see Zagaris, "The Caribbean Basin Initiative", supra note 3, at 1024.

7. For a discussion of the operation of the tax treaty and the Barbados offshore insurance legislation, see Karp, "Barbados is in Vogue as a Domicile for Captive Insurers", 13 *Tax Planning International Review* (July 1986) at 7.

8. For a discussion of the U.S.–Bermuda TIEA provisions and the background of its signing, see Zagaris, "U.S.–Bermuda Sign Mini-Tax Treaty Including Mutual Assistance, 2 *International Enforcement Law Reporter* (July 1986) at 191. The major U.S. Government impetus for the U.S.–Bermuda income tax treaty containing an exemption on insurance premium excise tax was to avoid paying rent for the U.S. nuclear submarine base in Bermuda. However, a reason for the Bermuda treaty and the excise tax provision was that Bermuda could not compete in the offshore insurance industry without the provision. However, statistics show otherwise. Of the estimated 700 captive insurance companies that have been formed in Bermuda, the Cayman Islands, Vermont and Barbados in the years 1985 to mid-March 1988, 41% were domiciled in Bermuda as against 25% in the Cayman Islands, 16% in Vermont and 17% in Barbados. Of new captives formed in the years 1985, 1986, 1987 and 1988 to date Bermuda's share was 47%, 50.2%, 31% and 27%, respectively. By comparison Barbados' share of new formations for the same period was 5%, 13%, 26% and 19%, respectively. The statistics demonstrate that Bermuda grew faster than all other domiciles in this hemisphere during the period. See address delivered by E.H.C. Griffith, General Manager, Central Bank of Barbados to Breakfast Briefing of U.S. International Tax Planners at the Vista Hotel, Washington, D.C. on 19 April 1988, at 8-9.

9. Technical and Miscellaneous Revenue Act of 1988, Sec. 6139.

10. For a discussion of the protests against the branch tax as breaching U.S. tax treaties, see letter from the Governments of 13 major U.S. trading partners to Claiborne Pell, Chairman, Sen. Foreign Relations Committee, dated 20 April 1988, reprinted in "Major U.S. Trading Partners War Against Treaty Overrides", 39 *Tax Notes* (25 April 1988) at 523; Tax Council, accompanying a letter dated 2 October 1987, to Assistant Secretary Chapoton from Edward A. Sprague; Report of the Tax Section of the New York State Bar Association on the Override of U.S. Tax Treaty Provisions by Amendments to the Internal Revenue Code, 16 October 1987; Forry & Karlin, "Overrides, Conflicts and Interactions with U.S. Income Tax Treaties", 35 *Tax Notes* (25 May 1987) at 793.

11. For a discussion of the difficulties other CBI Governments have had politically with the TIEAs, see Zagaris, "International Enforcement – Money Movement and Related Matters" (unpublished paper given to International Fiscal Association, Southeastern Branch, Miami, 21 October 1988 at 23).

12. For a discussion of the CARIBCAN tax provisions, see Zagaris, "Canada's CARIBCAN: Another Incentive for Investment in the Caribbean", 2 *International Business and Trade Law Reporter* (July/Aug. 1986) at 23-24.

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assistance would help solve problems of revenue enhancement and tax equity in the Caribbean. The assistance can be through a regional organization such as the Center for Inter-American Tax Administrators (CIAT) or it can be direct.
- The U.S. should provide resources for the services sector, including tourism and cultural development.

The key to Caribbean economic development and diversification and to realization of sovereignty is education and training as part of an integrated services sector program.[13] Similarly, for Americans to view the Caribbean as a whole and thereby participate in congressional and policy discussions about the region rather than as a place to get sun, surf and sand, they must understand its history, and its current socio-political setting.

Assistance should be given to Caribbean universities and foundations, such as the Caribbean Agriculture and Research Development Institute (CARDI), the University of the West Indies, the Caribbean Association of Industry and Commerce (CAIC) and national chambers of commerce, their Associations of Manufacturers and their export promotion boards.

Assistance should be provided to the Caribbean in the critical "information industries". Transfer of technology in computer and telecommunications is especially required. In the past U.S. computer firms have started pilot projects in Jamaica that have been quite successful. The linkage between the United States and the Caribbean in data processing can be strengthened by training programs.

Export of Caribbean culture should be encouraged. Jamaica is the model.[14] Jamaica's market is sufficiently large and its infrastructure and organization such, that it has been able to export music to the United States and to a lesser extent films.

By assisting Caribbean societies to increase their visual and performing arts, both for indigenous and commercial reasons, they will accomplish several objectives:
(a) they will become more knowledgeable about their own culture and less dependent on foreign culture – a process central to true independence;
(b) they will expand the quality of their tourism product and foreign exchange without having to increase the number of tourists;
(c) the export of visual and performing arts will generate positive macroeconomic effects. The export of culture will benefit artists, stimulate prospective artists and serve to promote travel and investment in the country of export.

Cultural exchange programs should be strengthened. These programs bring U.S. and Caribbean peoples together in a more positive way.

The U.S. Government should take steps to improve the CBI Government Procurement Program, announced with much fanfare by Vice-President Bush in November 1985.

IV. PRACTICAL IMPLEMENTATION

A first step in this direction is for the Caribbean Basin Policy group headed by the U.S. Trade Representative ("U.S.T.R.") to convene a meeting and obtain views on the strengthening of the services sector in the Caribbean. In particular, enhanced roles can be played by the Peace Corps and the Executive Corps. If the U.S. Government and Congress declared that assistance to the Caribbean service sector was important, then the Executive working with state governments could encourage more state programs like the Florida Association of Voluntary Agencies for Caribbean Action (FAVA/CA) and integrate into such programs a services component.

Legislatively, inclusion of a provision that services, such as tourism and cultural development and, in particular, visual and performing arts, are part of the CBERA is required to overcome arguments by some myopic Congressional staffers that the law does not allow the U.S. Government to assist those sectors. Such a declaration can also motivate persons in the U.S. Government, state governments and private sector to support the services sector.

In the end, tangible economic incentives must be provided to motivate investment. This can be done either by allowing U.S. entities a tax credit for providing assistance to CBI non-profit organizations or by involvement of U.S. agencies in these projects.

V. ENSURING PROPER DIALOGUE WITH CBI BENEFICIARIES

In the end, the problem of the TIEA program is that it is designed by the U.S. Congress to meet the needs of the United States. Therefore, it emphasizes obtaining tax information from the Caribbean to meet U.S. enforcement goals of international tax, narcotics, and money laundering and provides for insufficient incentives.

Only when the CBI Governments have an effective opportunity to express their needs and implement them through a framework in which they have a real voice will the TIEA program work. Such a mechanism exists in the Lomé Convention, which provides bilateral negotiation between the European Community and the African Caribbean and Pacific Governments every 5 years, and previously in the Inter-American Committee on the Alliance for Progress (CIAP). CIAP acted as a consulting and coordinating agency and acted on the recommendations of a Committee composed of both the U.S. and donee countries.[15]

13. For a discussion of an integrated services sector approach to economic development and diversification, see Zagaris, "Economic Development and Diversification in the Caribbean", 7 *Harlem Third World Trade Institute Trade Winds* (Sept. 1988) at 27-31.
14. For background on the success of Jamaica in cultural development, see Nettleford, *Caribbean Cultural Identity* (1979).
15. For a discussion of CIAP and other mechanisms for the coordination of foreign assistance among donor Governments as well as among donor and donee Governments, see Zagaris, "The Rising Utility of the Public International Corporation", 6 *Denver Journal of International Law and Policy* (1976) at 43.

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VI. SHORT-TERM SOLUTIONS

In the short-term the CBI Governments can only obtain more incentives in the TIEA program by effectively persuading the U.S. Government that, until the United States provides the CBI Governments more incentives, they will not conclude TIEAs.

The CBI Governments will not be able to obtain TIEA benefits by only concluding Mutual Legal Assistance Treaties ("MLAT")[16], especially ones limited to drugs and crimes relating to drugs.[17] The reason is that the Treasury Department, independent of Justice, the Drug Enforcement Administration, Customs, wants and needs TIEAs. In 1989 and the foreseeable future the U.S. deficit will put pressure on tax compliance and revenue raising. Recently, the United States has realized that with the internationalization of business, the IRS will need to allocate more audit resources on international transactions.

On both short and long-term strategies, the CBI countries must act as a group. The United States will put more demands and penalties on Caribbean Governments as a result of Sec. 4702 of the Anti-Drug Abuse Act of 1988. It requires the conclusion of agreements to provide access to bank records in countries where money laundering may occur. If Governments do not conclude agreements in 2 years, their financial institutions will be precluded from the U.S. wire transfer and clearing system and prevented from having accounts with banks chartered by the U.S. and state governments.

The Caribbean Governments must be united to achieve incentives under U.S. trade laws, such as the CBERA, and to cooperate in enforcement matters in a way that both solve drug trafficking and does not surrender their own sovereignty or reduce business opportunities, especially in countries in which there is an offshore financial sector.

The U.S. Government should avoid unilateral and extraterritorial solutions, or risk deterioration of its overall international enforcement goals in the region. A mature, unilateral policy, although it will take longer to implement, will produce more effective dividends, both for U.S. enforcement goals and for overall diplomatic goals in the region.

VII. SUMMARY AND CONCLUSION

Through an income tax treaty program that includes tax information exchange and technical assistance in tax administration and by increasing incentives in the services sector, the United States will enhance the motivation for the CBI beneficiary Governments to conclude TIEAs. The United States must also be able to fulfill whatever agreements it makes and compensate Governments that suffer its breaches of treaty obligations. From a negotiating perspective, unity among CBI beneficiaries is important as is constructive dialogue between CBI countries and the United States. In the long run only an institutional and unilateral framework can best insure the continuity of the dialogue.

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16. For a discussion of recent U.S. MLAT policy, see Ellis and Pisani, "The United States Treaties on Mutual Assistance in Criminal Matters", Bassiouni (ed.), *International Criminal Law* (1986) at 151-81; Nadelmann, "Criminal Assistance Treaties", *American Journal of Comparative Law* (1985) at 467-504.

17. For a discussion of the U.S.–Cayman Convention Supplementing the Single Convention on Narcotics, also known as the mini-MLAT, see Zagaris, "Exchange of Information Outside of Tax Agreements", Gordon & Zagaris (eds.), *International Exchange of Tax Information – Recent Developments* (PLI 1985) at 94-98; for a discussion of the U.S.–Cayman MLAT, see Zagaris, "U.S. and Cayman Islands Conclude Mutual Assistance Treaty", 2 *International Enforcement Law Reporter* (July 1986) at 200.

ERRATUM

The article appearing in the February issue, entitled "The United Kingdom Approach to Anti-tax Avoidance Provisions" was prepared in advance of the seminar by Mr. Eric Tomsett on behalf of Mr. Stephen Edge.

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Residence in the United Kingdom and the Scope of U.K. Taxation for Individuals – A Consultative Document

M. Roger Moore, FCA and Nick C. Webb*

INTRODUCTION

On 28 July 1988 the Inland Revenue issued a Consultative Document outlining its proposals for a change in the rules which determine the tax residence status of an individual and the way in which this affects liability to U.K. taxation.[1] One of the more radical options put forward in the Document would abolish the remittance basis of taxation currently available to individuals who are not domiciled in the United Kingdom. Another proposal would put an end to the rule that having accommodation available in the United Kingdom in conjunction with one day's presence in a tax year may be sufficient to make an individual resident for that tax year.

THE PRESENT SYSTEM[2]

There are currently 3 factors which determine the scope of an individual's liability to U.K. taxation – domicile, residence and ordinary residence. Domicile is a common law concept and can be defined as meaning the country in which a person has his home and in which he intends to live permanently. Residence has no technical meaning for U.K. tax purposes[3] and the Courts have stressed that the word is to be construed according to its everyday usage. The considerations typically taken into account in deciding whether an individual is a U.K. resident are referred to below. Ordinary residence, similarly, has no technical meaning and the words have to be interpreted in their ordinary sense. Case law indicates that ordinary residence signifies the place where a person habitually lives.

Behind the document lies the Inland Revenue's concern that the complexity of these residence rules and the ways in which these affect an individual's liability afford a number of opportunities for escaping U.K. taxation. These opportunities principally involve the following 4 aspects of the current system:

1. The remittance basis for non-domiciled individuals

Non-domiciled residents are subject to tax on foreign-source income and capital gains only when these are remitted[4] to the United Kingdom. Furthermore, such non-domiciled residents are not taxed on the importation of funds from foreign capital accounts except where these are funded by the proceeds of capital gains and therefore caught under the remittance basis. It is thus possible for non-domiciled residents to arrange their affairs by compartmentalizing their funds in separate capital and income accounts and importing only funds from capital accounts which do not attract U.K. tax.

2. "Not ordinarily resident status"

Though resident, an individual may sometimes successfully claim to be not ordinarily resident if he normally lives outside the United Kingdom. This status places the individual in the same advantageous position as an individual who is not domiciled in the United Kingdom with regard to foreign-source investment income. A further advantage is that earnings from employments performed wholly abroad are taxed only when remitted to the United Kingdom.

3. The method of determining tax residence status

Under the current system presence in the United Kingdom for 183 days or more in one year always makes an individual resident for tax purposes. When an individual is present for less than 183 days in a year a number of factors are generally weighed in determining whether or not he is a resident. Tax residence status is thus sometimes avoided by limiting visits to the United Kingdom to less than 6 months in a year and ensuring that other pointers to resident status are absent. The availability of accommodation in the United Kingdom, the possession of a permanent home abroad, and the average time present in the United Kingdom in any one year where visits are habitual are among the relevant considerations.

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* Mr. Moore and Mr. Webb are staff members of the IBFD.

1. The Inland Revenue also invited responses to these proposals.
2. See R.J. Tootle, "Inward Expatriates", 28 *European Taxation* 2 (1988) at 43 for a discussion of some of the relevant aspects of the present system.
3. The Taxes Act does, however, contain a number of sections which deem an individual to be resident or not resident in specific circumstances.
4. The phrase used in the Taxes Act is "received in the United Kingdom". The definition attached to this phrase in relation to employment income means that income is regarded as remitted to the United Kingdom when the employee has the use of it. See Taxes Act 1988, Sec. 132(5). No definition is given to the phrase in relation to investment income but it is amplified in such a way as to make it clear that what is envisaged is any commercially recognized method by which money may be transferred to the United Kingdom. The Courts, however, have shied away from interpretations which involve the concept of "constructive remittance", emphasizing that there must be an actual transfer of money or money's worth. See *Gresham Life Assurance Society vs. Bishop*, 4 *Tax Cases* (T.C.) 464 and *Thomson vs. Moyse*, 39 T.C. 291.

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4. The possibility of fiscal emigration

Individuals who are not resident are not subject to tax on capital gains arising from the disposal of U.K. assets and short-term absences are sometimes arranged in order to secure this result. Similarly certain income received by individuals carrying on a trade or profession may escape U.K. taxation entirely where the individual is able to arrange matters so that he is outside the country for a full year.

THE PROPOSALS

1. Residence

It is proposed that the possession of accommodation available for use in the United Kingdom should no longer play a part in deciding whether an individual is resident. The sole criterion to be admitted in determining residence status would be the number of days physically spent in the United Kingdom. The residence test suggested in the Document may be summarized as follows:

(a) less than 30 days' presence in the United Kingdom: not resident;
(b) 183 days' presence or more in the United Kingdom: resident;
(c) between 30 and 183 days' presence in the United Kingdom: resident where the total of the days present in the tax year and a fraction of the days present in the previous year and the year before that exceeds 183. The fractions proposed are ⅓ for the previous year and ⅙ for the year before that.[5]

2. Short absences abroad – capital gains

Measures are proposed to counter exploitation of the capital gains tax exemption for non-residents by individuals who absent themselves for short periods whilst substantial capital gains are realized. Income and gains arising during a period of short-term non-residence (say up to 3 years) would be assessable upon the individual's return to the United Kingdom. It is doubtful whether the introduction of such a charge would scoop up much tax in respect of investment portfolio gains. Many of the U.K.'s 80 tax treaties give exclusivity of taxing rights to the country of residence of the alienator of most movable property (with the standard exceptions of the business property of permanent establishments, etc.). It would seem, therefore, that the new measure would not catch the portfolio gains of short-term emigrants who take up residence in one of these treaty countries unless – and it is sincerely hoped that this will not be the case – the proposed legislation seeks to override existing international agreements.

For the moment it seems that as far as investment portfolio gains are concerned, sanctuary from the new proposal may be found by taking up residence in a country which has a tax treaty with the United Kingdom, which incorporates the substance of Art. 13 of the OECD Model; for example, Switzerland, Belgium or Luxembourg – but not the Netherlands, because of Art. 13, para. 5 of the treaty.[6]

Although the Art. 13 exclusivity provision is found in most of the U.K.'s tax treaties in relation to movable property gains only those with South Africa and Zambia still have the exclusivity provision for immovable property gains.[7] Apart from these 2 cases, therefore, the U.K.'s treaty network would present no obstacle to the proposed assessment of individuals returning to the country on capital gains arising from immovable property.

The interaction of the proposals with the provisions of a tax treaty is illustrated in the following example. Hector's investment portfolio shows accrued taxable gains of £ ½ million. In November 1992 Hector takes up residence in Switzerland where he has full-time employment and his circumstances are such that under Art. 4 of the United Kingdom–Switzerland tax treaty (elimination of dual residence) he is resident only in Switzerland for purposes of the treaty. In February 1993 Hector realizes his £ ½ million gain. There is no federal capital gains tax in Switzerland, and Hector has taken care to reside in a canton which likewise does not assess individuals to tax on capital gains. In May 1994 Hector returns to the United Kingdom. The U.K. Inland Revenue should not be able to assess this gain to capital gains tax, either in the year in which it was made if they find Hector to be U.K. resident for that year under domestic law, or under the new proposals in the year of Hector's return to the United Kingdom. Under Art. 13 of the tax treaty, Switzerland has the exclusive right to tax the gain, and the situation is not affected by the fact that neither Switzerland nor the canton in which Hector resided exercises the right.

Now suppose that Hector's £ ½ million gain does not arise from his investment portfolio, but from immovable property situated in the United Kingdom: the Inland Revenue will be able to assess as Switzerland does not have exclusivity of taxing rights in respect of U.K. immovable property gains.[8] In a recent case, *R v. Inland Revenue, ex parte Fulford-Dobson*[9], the taxpayer was assessed to capital gains tax in respect of a substantial immovable property gain realized after his departure from the United Kingdom for employment

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5. Changing the existing rule, a part of a day will count as a full day. Currently, an individual is deemed to have been a full day in the United Kingdom only if he has been present immediately before midnight; in other words, if he leaves the United Kingdom 5 minutes before midnight, the day does not count as a day for tax residence purposes.

6. The relevant part of Art. 13 of the Netherlands–United Kingdom tax treaty reads:

> (4) Gains from the alienation of any property other than that referred to in paragraphs (1), (2) and (3) of this Article, shall be taxable only in the State of which the alienator is a resident.
> (5) The provisions of paragraph (4) shall not affect the right of either of the States to levy according to its own law a tax on gains from the alienation of any property derived by an individual who is a resident of the other State and has been a resident of the first-mentioned State at any time during the five years immediately preceding the alienation of the property.

7. See M. Roger Moore, "Darkness over the Antilles and Aruba", 28 *European Taxation* 9 (1988) at 311. The outgoing Netherlands Antilles and Aruba treaty does contain this limitation provision but it neither appears in the outgoing Belgian treaty nor in the new (not yet ratified) Belgian treaty.

8. The same exception applies to immovable property situated outside the United Kingdom as applies to investment portfolio gains.

9. 1987 *Simon's Tax Cases* 344.

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in Germany. As in the case of the current tax treaty with Switzerland, there is no exclusivity of taxing rights provision in respect of immovable property gains in the United Kingdom–Germany tax treaty.

As a possible alternative to making short-term absentees liable to capital gains tax on their return to the United Kingdom, the idea of a deemed disposal of assets on emigration is raised. Australia and Canada both treat emigration of individuals as a deemed capital gains tax disposal, and the system appears to operate quite satisfactorily. However, although an emigration charge has the advantage that its provisions would not run the risk of conflicting with an international tax treaty[10], the Document appears to dismiss the possibility of such a charge on the grounds that it would be difficult to ensure compliance.

3. Short absences abroad

The Consultative Document also proposes that certain types of income receipts (for example, sales of copyright for lump sums) received during a period of short-term non-residence which would otherwise elude the U.K. tax net will be subject to a certain amount of U.K. income tax in the years immediately preceding and following the period of non-residence. As with capital gains, the Inland Revenue will have to consider any exclusive taxing rights in a tax treaty with the taxpayer's country of residence before attempting to assess such income.

4. Inward expatriates

The Document comments that the favourable tax treatment currently available to non-domiciled residents is inappropriate when such individuals have lived in the United Kingdom for many years and possibly their whole lives. It concedes, on the other hand, that there are grounds for extending such a favourable "intermediate basis" of taxation to inward expatriates for a temporary period only.

Two alternative solutions to the problems presented by the treatment now afforded to non-domiciled residents are outlined. The first, which is apparently favoured, envisages retaining the concept of domicile and making the intermediate basis of taxation available to non-domiciled residents until they are sufficiently "fiscally connected" to the United Kingdom to be subject to full taxation. Sufficient fiscal connection would be established when the individual has been resident for a certain number of years – 7 out of the previous 14 years is suggested. The second approach advocates abandoning the concept of domicile entirely and extending the intermediate basis of taxation to any resident individual who has not been resident for 7 out of the previous 14 years.

The Document also puts forward 2 alternative proposals for the form which the intermediate tax treatment of inward expatriates should take: (1) a widened and strengthened version of the present remittance basis; or (2) a world-wide income approach.

The first alternative would bring into charge to U.K. tax all benefits enjoyed in the United Kingdom out of overseas assets with the result that the current advantages in remitting only from capital funds would evaporate. The Document highlights the proceeds of jewelry, antiques, etc. brought into the United Kingdom and sold whilst the owner is resident and the value of benefits from interest-free loans and rent-free use of property provided out of overseas assets as items which would fall into this expanded remittance net. The amount brought into charge would of course be subject to a limit equal to the amount of world-wide income and gains and there would be a credit for any tax otherwise payable. Because of the complexities involved, this proposal apparently does not find favour with the Inland Revenue.

The second form of intermediate taxation would require the calculation of world-wide income and gains. Only a proportion of the tax liability on world-wide income and gains would be taken into account. This proportion would be variable and would be linked to the number of years of residence in the period before full U.K. tax liability was established. The "intermediate resident" would, however, be taxed on the full amount of income and gains arising in the United Kingdom where this produced a higher liability.

Whichever method of intermediate taxation was adopted – be it a strengthened remittance basis or a world-wide income approach – it is worth reiterating that inward expatriates would pay full U.K. tax on world-wide income and gains after a limited period (probably 7 years) of residence.

CONCLUSION

It is expected that, if adopted, the proposals will be incorporated in the Finance Bill 1989, with the intention that they would come into effect in the tax year 1990-91. Doubtless there will be powerful opposition to these proposals from interested parties, and it must not be forgotten that an attempt by the Government in 1974 to strip the non-domiciliary of his remittance basis of taxation after 5 years' ordinary residence[11] foundered, albeit on the then weakness of sterling and the U.K. economy, and the strength of overseas pressures.

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10. To be fully effective, it would have to apply on an individual becoming dual resident in a treaty country, as well as becoming non-resident. Provisions along the lines of Finance Act 1986, Sec. 58 (dual resident trusts) might be necessary.

11. Clause 18 of the 1974 Finance Bill reads as follows:

Ordinary residence for substantial periods

(1) Where an individual –

(a) is ordinarily resident in the United Kingdom in a year of assessment to which this section applies, and

(b) was ordinarily resident in the United Kingdom in the preceding 6 years of assessment or in 5 of them; the same consequences shall follow for the purposes of income tax and capital gains tax as if in the first-mentioned year of assessment he were domiciled in the United Kingdom.

(2) This section applies to the year 1976-77 and subsequent years of assessment.

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Portuguese Tax Reform:

A Closer Look at Corporate Taxation

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INTRODUCTION

In the February 1988 *Bulletin*[1] I outlined the overall framework of Portuguese tax reform. This article deals in greater depth with the corporate aspect of the tax reform, which is effective as from 1 January 1989. The relevant tax codes were approved by the Cabinet on 20 October and signed into law (Decree-Law 442-B88 of 30 November) by the President on 30 November 1988. The new tax is more commonly referred to in the abbreviated form of its Portuguese title: "Imposto sobre o Rendimento das pessoas Colectivas" (IRC) (hereafter "corporate tax"). Persons liable to the tax are defined as:

(a) Commercial or civil companies in commercial form, cooperatives, nationalized corporations and other collective persons under public or private law having their head office or place of effective management in Portuguese territory.

(b) Entities without juridical personality, having their head office or place of effective management in Portuguese territory, receiving income not liable to the tax on individuals or to corporate tax directly as individuals or companies.

(c) Entities with or without juridical personality, not having their head office or effective place of management in Portuguese territory, which obtain income from there not liable to tax on individuals.

Taxable base

The Code defines the taxable base under 4 categories:

- The profit of taxable entities which carry on activity of a commercial, industrial or agricultural character.
- The global revenues of resident entities not carrying on activity of a commercial, industrial or agricultural character.
- The profit attributable to the Portuguese permanent establishment of non-resident entities.
- Revenues of various types defined for purposes of the tax on individuals, received by non-resident entities not liable to the tax on individuals.

Profit is defined in balance sheet terms, as representing the difference between the net equity at the beginning and end of the accounting period, adjusted in accordance with the Code. This clearly embraces capital gains, but, to eliminate doubt, the Code develops further the concept of taxable gains, to include the world-wide revenues of resident companies and a detailed list of gains of non-resident entities. For non-Portuguese readers, these are of particular relevance.

Non-residents with a permanent establishment in Portugal

In addition to the income and capital gains directly earned by a Portuguese permanent establishment, non-resident companies are also liable to tax on income or gains of whatever character obtained through the intervention of the permanent establishment, or through the conduct in Portugal of identical or similar activities to that of the permanent establishment.

It is worth noting in passing that the definition of a permanent establishment, which previously was virtually a word-for-word transcription of the OECD Model definition, has now been re-drafted to contain fewer exceptions and qualifications. A permanent establishment is now defined in Art. 4(5) as "....any fixed installation or permanent representation through which an activity of commercial, industrial or agricultural character is carried on".

A permanent establishment is also deemed to exist where a non-resident entity carries on its activity in Portugal through employees or other personnel contracted for that purpose for a period of 120 days, not

1. See: "Portuguese Tax Reform", 42 *Bulletin for International Fiscal Documentation* 2 (1988) at 78.

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necessarily consecutive, in any 12-month period. With Portugal's tiny network of tax treaties[2], this leaves many non-resident companies exposed to corporate tax.

Non-residents without a permanent establishment in Portugal

These are liable to corporate tax on:
(a) Income from immovable property situated in Portugal, including capital gains arising on their disposal.
(b) Gains arising from the sale of shares or other titles of ownership or securities issued by entities with their head office or place of effective management in Portuguese territory.
(c) Gains arising from the sale of the assets referred to in preceding paragraphs, even where their issuer is a non-resident, wherever the dividends or interest on the shares or securities arose from a permanent establishment in Portugal.
(d) The following types of income paid by a Portuguese resident debtor (or by a Portuguese permanent establishment of a non-resident debtor) to a non-resident:
(i) income from intellectual or industrial property and from the provision of information derived from experience acquired in the industrial, commercial or scientific sectors;
(ii) other income from the application of capital;
(iii) income from the use or granting of use of agricultural, industrial, commercial or scientific equipment;
(iv) income arising from the holding of an office as a member of statutory boards of collective persons;
(v) winnings from gambling, lotteries or sweepstakes.

The rate of tax applicable to non-residents without a permanent establishment is 25%. However, for the following categories of income special reduced rates apply:

– Income described in (i) and (iii) above, as well as technical assistance fees	15%
– Income described in (ii) and (iv) above, except for dividends and interest on bearer or nominative securities	20%
– Income described in (iv) above	25%

The tax is to be deducted at source.

PRINCIPAL INNOVATIONS IN THE 1989 TAX REFORM

The new Code introduces some changes which will radically alter the timing and scale of the compliance and payment burden for companies.

Taxation of capital gains

The widening of the tax base, described above, resulted in capital gains being liable at the corporate tax rate of 36.5%, increased by a municipal surcharge to 40.15% in most municipalities. This contrasts with the previous regime under which capital gains of companies were taxed only if realized on the disposal of fixed assets, and the rate was 12% (doubled to 24% for gains on the disposal of land for construction).

The introduction of "rollover relief" for reinvestment of sales proceeds will ease the burden on active or expanding companies.

Consolidated tax reporting

The new tax adopts the concepts introduced into law in December 1987 (Decree-Law 414/87 of 31 December), permitting resident groups of companies to file a single tax return.

The ownership requirement, at 90%, is an onerous one which during 1988 is believed to have resulted in only 7 applications for consolidated reporting being submitted. (Senior tax officials advocate the use of a 100% requirement!) In addition to permitting pooling of profits and losses of member companies, the consolidated reporting option permits payment of dividends, interest and royalties between group members without deduction of withholding tax. Intra-group disposal of fixed assets is not liable to capital gains tax.

Applications for consolidated reporting must be submitted before 30 April in the year for which the application is intended to be effective. If granted, consolidated reporting is obligatory for 3 consecutive years, after which it is renewed automatically unless the group parent submits a request for its discontinuance.

Intra-group dividends

The changes in this area result in a higher tax burden for companies receiving dividends from other Portuguese resident companies. Under the old system Art. 42 of the Industrial Tax Code permitted such companies to exclude from taxable income dividends received from other resident companies. A minimum holding percentage of 25% and holding period of 2 years applied for many years, but the first of those was abolished in 1986. This encouraged widespread minority holdings by companies in others.

With tax reform, the minimum holding period is retained, and the 25% holding requirement reintroduced. The old 100% exclusion is replaced by a 95% one. Companies not meeting these 2 requirements are taxed on the full dividend received, with a credit for 20% of the underlying corporate tax as well as for the withholding tax on the dividend. This results in the following situation:

2. Portugal has tax treaties with Austria, Belgium, Brazil, Denmark, Finland, France, Germany (Federal Republic), Italy, Norway, Spain, Switzerland and the United Kingdom.

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Company A receives dividends from Company B in 3 different ownership situations, all held for longer than 2 years.

	I	II	III
	<25%	>25%	100% [consolidation]
Profits of Company B	10,000	10,000	10,000
B's corporate tax	4,015	4,015	4,015
Distributable profits	5,985	5,985	5,985
Distributed to Company A	1,000	1,000	1,000
Withholding tax on dividends	250	–	–
Received by Company A	750	1,000	1,000
Taxable in Company A			
1. The sum of:			
– Dividends received 750			
– Withholding tax 250			
– 20% of underlying corporate tax 121.97 = 1122			
2. 5% of dividend		50	
3. If consolidated reporting elected			0
Tax payable by Company A			
Corporate tax 36.5%	410	18	0
Municipal surcharge 3.65%	41	2	0
Credits 250 + 121.97	–372		
	79		
Net after-tax dividend received by Company A	671	980	1000

Notes: *1.* If the >25% holding were not held by A for the required 2-year period, the after-tax dividend would be reduced from 979.925 to 671.45.

2. If A did not elect consolidated reporting in relation to its holding in B, the after-tax dividend would be reduced from 1000 to 979.925.

Separate legislation relating to the taxation of holding companies is currently being drafted and, when passed, may provide for more uniform treatment of dividends at various ownership levels where the relationship meets the requirement for qualifying the recipient as a "holding company" under Portuguese law. This definition, not yet known, will be a crucial part of the holding company legislation.

Computation of taxable profits

The present system, involving maximum percentages for provisions for bad and doubtful receivables and inventory obsolescence is to be refined. The definition of a bad debt has been extended beyond the present one which required a court judgement before a write-off could be tax-deductible, to embrace debts over 6 months overdue. Debts of that age and older may be provided for on a stepped basis:
25% for debts 6 to 12 months overdue
50% for debts between 12 and 18 months overdue
75% for debts between 18 and 24 months overdue
100% for debts more than 24 months overdue

Inventories may be written down to the lower of cost or market value. The previous 10% inventory obsolescence provision will not be automatic.

Both the above tax deductions are taken by setting up provisions, rather than by direct credit against the current assets involved.

Valuation of work in progress

Under the present tax legislation, there is no specific reference to the manner of recognizing profit on long-term contracts spanning 2 or more accounting periods. As a result, a highly conservative practice has developed of recognizing profits only on completion of long-term contracts. In the case of construction companies, the latest date that could be taken as indicating completion was the date of execution of the public deed or "escritura pública" conveying the completed property to the new owner or in the case of works carried out on a person's own property. Needless to say, this has been seized on enthusiastically by building contractors and others in the past to maximize tax deferral.

The new Code requires the use of the percentage of completion method for construction works carried out on a contract basis. Other long-term production processes may still use other valuation criteria, which eases the significant tax burden that would otherwise result for wine and port wine producers holding large stocks.

Fiscal transparency

This is the term used in the legislation to the provisions which look through professional service companies and family holding companies and attribute their income pro rata to their shareholders. Companies of lawyers and statutory auditors are the entities subject to the "look-through" provisions.

Farming and forestry activities

To ease these into the tax system, transitional arrangements provide for a reduced basis of taxation as follows:

	tax rate
Profits of 1989	12.5%
Profits of 1990	16 %
Profits of 1991	20 %
Profits of 1992	25 %
Profits of 1993	31 %

Payment dates

Previously corporate tax was paid either when filing the tax return, with a discount, or later on demand. From 1989 onwards, 3 payments on account are required in June, September and December. Each payment is to be 25% of the previous year's liability.

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CONCLUSION

The above is necessarily an overview of only some of the more interesting changes introduced by Portuguese tax reform. The purity of the original single tax concept as developed by the Commission on Tax Reform has been diluted by the introduction of special rates for various categories of corporate and personal income.

Despite this flexibility, no unilateral measures have been introduced to overcome Portugal's comparative tax disadvantage in attracting investors from non-treaty countries (the United States, Japan, the Netherlands, etc.). The imposition of a higher dividend withholding tax than the 10% to 15% treaty maximum and the previous 12% is a negative step which will adversely affect existing investors from these countries. The combined rate of corporate tax, municipal surcharge and dividend withholding tax of 52.12% is higher after tax reform than under the previous system, where the corresponding rate for 1987 was 48.08%.[3] The result of tax reform, therefore, will be to increase the tax burden on companies distributing profits and to reduce it for those retaining them.

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3. A combination of industrial tax of 35%, extraordinary tax on corporate profits of 2.5%, a municipal surcharge of 3.5% and a dividend withholding tax of 12% from income net of these 3 taxes.
The rate of tax applicable to non-residents without a permanent establishment is 25%. However, for the following categories of income, special reduced rates apply:

– Income described in (i) and (iii) above, as well as technical assistance fees	15%
– Income described in (ii) and (iv) above except for dividends and interest on bearer or nominative securities (dividends paid by Sociedades por Quotas are regarded as not related to shares or securities and therefore qualify for the 20% rate)	20%

The tax is to be deducted at source.

Conference Diary

MARCH 1989

Oort I en Oort II – Wat zijn de consequenties in de praktijk voor uw onderneming? Amsterdam, 1 March (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

European Tax – Development in International Corporate Tax Planning. Amsterdam, 9-10 March (English):
Seminar Services S.A., 7a boulevard de Pérolles, Ch-1700 Fribourg, Switzerland.

Fundamental Elements of U.S. Federal Taxation. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S./International Taxation – Tax Strategies for Cross Border Activities. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

U.S. Taxation: Oil and Gas – including International Aspects. Lesigny, 13-18 March (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Foreign Investment in the U.S.: Strategies for Corporate Success. London, 14 March (English):
Dimitra Poulis, Business International Corp., 215 Park Avenue South, New York, NY 10003, U.S.A.

Münchner Steuerfachtagung 1989 – Steuerpolitik und Steuerrecht; Kapitalerträge und Zinsen nach der Steuerreform 1990; Aktuelle Fragen der Unternehmensbesteuerung; Verfahrensrecht; Internationales Steuerrecht – Europafragen. Munich, 15-17 March (German):
Münchner Steuerfachtagung e.V., c/o Lehrstuhl Prof. Dr. Klaus Vogel, Ludwigstrasse 28 Rückgeb., 8000 München 22, Federal Republic of Germany.

Het kopen en verkopen van participaties in B.V.'s. Rotterdam, 16 March (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Japanese Tax Reform. London, 21 March (English):
British Branch IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

Doing Business with China. Brussels, 23-24 March (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

APRIL 1989

The Inland Revenue's approach to captive insurance companies. London, 4 April (English):
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Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

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Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

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British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

NOVEMBER 1989

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

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ZIMBABWE:

Budget 1988/89

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GENERAL

Two important pieces of tax legislation were published in 1988: the Finance Act, 1988 (Act No. 4 of 1988), promulgated on 23 September 1988, and the Finance (No. 2) Act, 1988, promulgated on 25 November 1988. The dates of the formal promulgation of these 2 enactments are of little practical interest since nearly all of the amendments contained therein are expressly stated to come into effect at the beginning of the 1988/1989 tax year which is 1 April 1988 or, for the purposes of quantifying taxable income or capital gains, the first day of the substituted accounting year that has been approved by the Commissioner of Taxes.

Without doubt the single most important change in taxation that has been brought about for 1988/89 is the introduction of separate taxation of spouses who hitherto were charged as one taxpayer on their combined taxable income, in the name of the husband. As a direct consequence of this change, it was possible to also introduce, as was done, a single scale of progressive rates of income tax for all individuals whether married or single.

The new concept of separate taxation for all spouses required transitional legislative provisions which disentangle the conjoint rights and obligations of a married couple as they existed on the last day of the 1987/88 tax year. Suffice it to say here that these transitional provisions operate to allow the separate rights and obligations of the female spouse, as they actually existed on this last day, to pass separately to her on the first day of the 1988/89 tax year without creating any further additional rights or obligations.

RATES OF INCOME TAX

Companies and trusts:[1]	50% of each dollar of taxable income
Other taxpayers:	
Level of taxable income (Z$)	rate of tax for each dollar of taxable income (%)
Up to 1,800	Zero
1,801 to 4,500	20
4,501 to 9,000	30
9,001 to 13,500	40
13,501 to 23,000	50
23,001 to 33,000	55
33,001 and more	60

NB: Foreign dividends are still taxed gross at the previously existing rate of 20%.

Prior to 1988/1989 the rates of tax comprised 2 separate elements. Each dollar of the taxable income of a company was charged to a basic rate of tax of 45% and the basic tax was then increased by a surcharge. The 1987/88 rate of surcharge for a company was 17.5% which gave an effective rate of 52.875% as compared with 54% for the immediately preceding year. Before 1988/89 taxpayers other than companies had 2 separate scales, each containing different progressive rates of tax. A married couple was charged on its combined taxable income with the excess over Z$ 17,000 being charged at the rate of 45%. The first Z$ 16,000 was charged in bands of Z$ 1,000 each at 10% for the first Z$ 1,000 with a rise of 2% in the rate of charge for each band. The seventeenth thousand was charged at the rate of 42.5%. The other scale charged taxable income in excess of Z$ 15,000 at the rate of 45%. The first Z$ 14,000 was charged in bands of Z$ 1,000 each, at 14% for the first Z$ 1,000 with a rise of 2% in the rate of charge for each band. The fifteenth thousand was charged at the rate of 42.5%. The tax calculated under either of these 2 scales was then reduced by the tax equivalent of the taxpayer's personal abatements (see below under "Income Tax – The Tax Credits") with married taxpayers enjoying a further reduction of up to a maximum of Z$ 810 which was related to the female spouse's earned income and was designed to alleviate, although not eliminate, the hardship caused by the levy of tax on the combined taxable income of the 2 spouses. The residual balance of tax chargeable, after making these reductions, was then increased by the levy of a surcharge the rates of which were 15% on the first Z$ 4,000 of tax, increasing by one percentage point for every additional Z$ 1,000 of tax up to a total of Z$ 7,000, by a further 2 percentage points for each Z$ 1,000 up to Z$ 12,000. Tax in excess of Z$12,000 was subject to a surcharge of 33.33%. Thus the maximum effective rate of income tax (45%) and surcharge (33.33%) was 60% and it could become leviable on a married couple for every dollar of their taxable income that exceeded Z$ 34,634, and on an unmarried person for every dollar over Z$ 32,918.

A notable change for 1988/89 is that the rate of tax leviable on a trust is the same as that leviable on a company whereas, previously, the trust was assessed on the same basis as an unmarried individual. However, a trust remains assessable only on income to which no beneficiary is entitled.

The top rate of income tax for 1988/89 for a company is 50% but it is 60% for an individual, a deceased estate, an insolvent estate or the estate of an individual who is under a legal disability. However, dividends paid by local companies are subject to a withholding tax of 20% unless paid to other local companies. With 20% being levied on the distributed after-tax profits of companies, the maximum rate of tax on the company and the individual is, at least in theory, the same.

The rates of other taxes remain unchanged for 1988/89.

1. A trust in this context does not include a deceased estate, an insolvent estate or the estate of an individual under a legal disability.

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These are 8.4% for branch profits tax chargeable on the taxable income of foreign companies, 30% for capital gains tax, 10% for withholding tax on interest and 20% for withholding tax on dividends, fees, royalties and remittances from Zimbabwe of allocable expenditure.

In his Budget Speech on 28 July 1988 the Minister of Finance, Economic Planning and Development, Dr. Chidzero, announced his intention to impose a special tax on the windfall profits earned by financial institutions on blocked funds deposited with them by non-residents who could not, because of Government regulations, be paid interest at a rate higher than 5%. At the present time no further details have been published concerning this special tax.

INCOME TAX – THE TAX CREDITS

Prior to 1988/89 personal allowances were granted in the form of abatements. This system was somewhat laborious in that having determined the total amount of the allowable abatements this figure then had to be converted into its tax equivalent by applying the basic rates of tax, i.e. the surcharge was ignored. The converted figure was then applied to reduce the tax on the taxable income and the surcharge was levied on the balance after allowing any further reduction that might have been due in respect of the earned income of a married woman.

For 1988/89 and subsequent tax years, the personal allowances take the form of tax credits and the total of the amount of the allowable tax credits is deducted directly from the tax chargeable on an individual's taxable income at the new rates of tax set out above. Abatements were, and tax credits are, denied to the company. The trust which is chargeable at the company rate of tax previously enjoyed the primary abatement allowable to a single person but from 1988/89 is not entitled to any tax credit. The allowable tax credits and the comparable figure of the earlier abatements are as follows:

	Tax credit Z$	*Abatement* Z$
I. PRIMARY		
Family taxpayer – without a spouse who has taxable income	360	3,000
Family taxpayer – with a spouse who has taxable income	nil	3,000
Single taxpayer	nil	1,800
II. CHILDREN AND DEPENDANTS		
Unmarried lawful minor child	120*	600
– child, a full-time student under 26	120*	400
Unmarried wholly maintained minor	120*	600
Unmarried wholly maintained full-time student under 26	120*	400
Statutory standard dependent credit	50	N/A
III. INSURANCE & BENEFIT FUND CONTRIBUTIONS		
– 20% of payments, maximum	400	—
– payments, maximum	—	600
IV. MEDICAL EXPENSES		
– 20% of payments over Z$ 250	Actual	—
– payments less Z$ 72	—	Actual
V. ELDERLY PERSON		
– only if taxable income is under Z$ 5,000	100	—
– married – taxable income less than Z$ 4,000	—	Actual
– single – taxable income less than Z$ 3,000	—	Actual
VI. INCAPACITATED INDIVIDUALS		
Blind taxpayer, statutory	500+	2,000
Disabled, not blind, taxpayer, statutory	500+	—
expenses up to maximum of Z$ 2,000	—	Actual
Disabled child, each, statutory	500+	—
expenses up to maximum of Z$ 2,000	—	Actual
Maximum of credits in II above		
– family taxpayer	770	3,600
– single taxpayer	410	2,000

* Any amount unused by a male spouse is transferable to the female spouse.

\+ Any amount unused by the disabled taxpayer is transferable to his or her spouse.

The loss of the Z$ 1,800 abatement allowed to a single person before the 1988/89 tax year is compensated for by the Z$ 1,800 band of taxable income which is now chargeable at the zero rate of tax. In a double-earner family, the taxable income of each spouse is charged separately to income tax and thus each gets the benefit of the zero and lower rates of tax. The single-earner family does not have this advantage since the benefit of the zero and lower rates can only be enjoyed once on the sole provider's taxable income. The allowance of the Z$ 360 tax credit to the single-earner family is apparently a gesture in mitigation of this discrimination.

Taken in relation to the previous figures for abatements and their conversion to tax credits appears to have been made, generally speaking, on a fair and reasonable basis. Most of the tax credits represent 20% or more of the earlier abatements but in previous years it was only when abatements totalled Z$ 11,000 for a married couple or Z$ 7,000 for a single person that their tax equivalent averaged out at 20%; very few taxpayers would have had abatements totalling Z$ 11,000 or Z$ 7,000.

COMPARISON OF TAX PAYABLE

Companies enjoy a reduction in the rate of income tax chargeable. The previous rate of 52.875% is reduced to 50%. Companies never were entitled to any abatements and they are not entitled to any tax credits. A trust that is chargeable at the company rate of tax has lost the benefit of the lower rates of tax chargeable for 1988/89 on taxable income up to Z$ 33,000; previously the trust was charged at the rates of tax applicable to a single person and even enjoyed the primary abatement of Z$ 1,800. No tax credits are allowable to a trust. However, distributions by a trust of its taxed income are not subject to any withholding tax whereas distributions by a company to its shareholders are subject to the 20% withholding tax.

Appendix A is a selection of comparisons showing the income tax chargeable for 1987/88 and 1988/89 on taxpayers other than companies or trusts chargeable at the 50% flat rate of tax.

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OTHER INCOME TAX AMENDMENTS

1. No deduction is allowed for alimony in determining the taxable income of the payer and alimony received is exempt from income tax. The only source of relief for alimony payments is now to be found in the system of tax credits.
2. Customary marriages contracted by the indigenous people of Zimbabwe are now recognized for income tax purposes but in the case of a polygamous marriage only a taxpayer's first wife can be recognized as a married woman or spouse in relation to the taxpayer.
3. The purchase cost of an annuity which has not been allowed as deduction to the payer at the time of his or her death is allowable as a deduction against the annuity received by the spouse of the deceased.
4. The deductible limits for amounts paid in a tax year as contributions to approved pension funds have all been increased by 25%. Another benefit of the separate taxation of the spouses is that the deductible limits now apply to each of the spouses separately, as do all other limited deductions, whereas previously the limits applied to the combined payments of the 2 spouses.
5. A school, hospital, nursing home or clinic on a farm, the construction of which was commenced on or after 1 April 1988 will enjoy the same capital allowances for income tax purposes that are available for other farm improvements. However, the tax-deductible cost of any one complex cannot exceed Z$ 100,000. The tax deductible cost of any one staff house for the complex cannot exceed Z$ 15,000. Similar provisions have also been enacted in relation to a complex used in connection with mining operations.
6. Where capital assets are transferred between spouses, they may elect that for income tax purposes the assets are transferred at their income tax values even if consideration is payable and even if it is higher or lower than the income tax values. The elections allow the spouses to avoid creating a taxable recoupment of capital allowances granted to the transferor. In the event of a further disposal to a non-spouse, the capital allowances granted to both spouses which are recovered or recouped are included in the seller's taxable income.
7. The limit to the qualifying cost in respect of housing for employees has been increased from Z$ 10,000 to Z$ 15,000 in respect of new constructions commenced on or after 1 April 1988.
8. Where otherwise taxable interest accrues to a taxpayer on any loan or deposit, the first Z$ 500 of the interest is not brought into the taxpayer's taxable income. This exemption does not apply to a company or a trust. The exemption does not discriminate between foreign and local interest and where double taxation relief is allowable to the recipient, the local tax authorities have agreed that the most burdensome interest can be excluded first.
9. The pension paid to a retired President of Zimbabwe and value of any service or facility provided to a retired President are exempt from income tax.
10. Other amendments to the Income Tax Act (Chapter 181): increase substantially the fines levied by the Courts for offences; provide for separate payment of tax by spouses; allow tax officials to enter business premises to examine or seize business records without a warrant provided they have reasonable grounds for doing so; and provide for stiff fines, with or without imprisonment, for hindering tax officials from carrying out their duties. The maximum penalty tax chargeable for fraud, omissions, etc. was reduced from 200% of the tax chargeable to 100% for the 1987/88 and subsequent tax years.

AMENDMENTS TO THE CAPITAL GAINS TAX ACT

Spouses are also separate taxpayers for the purposes of capital gains tax. Other amendments are:

1. A capital gain made by a taxpayer on the disposal of his principal private residence after 31 March 1988 and reinvested by the end of the following tax year by acquiring another principal private residence is not subject to tax if the taxpayer elects to roll over the capital gain by applying it in reducing the cost, for capital gains tax purposes, of the new acquisition. However, the total cost of the latter, not its reduced cost, earns the deduction of the statutory allowance, calculated as 5% of cost for each year or part of a year, in event of a further sale. If the whole of the capital gain is not so reinvested, a proportionate part, based on the ratio of sale proceeds reinvested to total sale proceeds, can be rolled over with tax becoming payable on the balance. Provisions exist which allow the roll-over treatment to be applied where the principal private residence is situated on a large area of land all of which is not required for the reasonable enjoyment of the dwelling as a principal private residence (e.g. where the taxpayer's home is situated on his farm); an apportionment can be made of the selling price of the property to determine the part that can be subject to the roll-over procedure. Provisions also exist to allow taxpayers who own their homes indirectly through shares in a company, which carry the right of occupation, to participate in the roll-over procedure.
2. Provisions identical to those described at "6" above (i.e. the other income tax amendments) exist for capital gains tax purposes in the 1988/89 and subsequent tax years and allow chargeable assets to be transferred free of tax between spouses. A more limited provision also exists which allows the taxpayer to similarly make a tax-free transfer of his or her principal private residence to a former spouse if the transfer is made under an order of court which allocates their assets on or after the dissolution of their marriage.
3. The levy of capital gains tax was first introduced on 1 August 1981. Chargeable assets that had been

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acquired otherwise than by way of purchase or inheritance (e.g. by donation) before this date did not have any cost for capital gains tax purposes unless, exceptionally, the donor had been subject to income tax on the value of the donation when such value was deemed to be the cost of acquisition by the donee. Should the donee dispose of a donated asset in the 1988/89 or a later tax year, he will be treated as having acquired this asset for a cost equal to its fair market value at the time before 1 August 1981 that he acquired it. No change has been made to the legislation in respect of assets similarly acquired on or after 1 August 1981. The cost to be donee is the value, if any, attributed to the donation for income tax and capital gains tax purposes in the hands of the donor. The cost of assets acquired by inheritance has always been taken as equal to their value for estate duty purposes in the deceased estate of the testator.

4. Other amendments to the capital Gains Tax Act (No. 54 of 1981): make transactions involving the acquisition and disposal of rights in deeds of sale for chargeable assets subject to tax; allow compensation received for the damage or destruction of a chargeable asset to be ignored for capital gains tax purposes to the extent that it is expended within 2 years from the date of the damage or destruction on the replacement, by purchase or construction, or repair of the asset; and confer rights of objection and appeal against assessments made under the new provisions of the legislation.

MISCELLANEOUS

The Estate Duty Act (Chapter 178) was amended to exempt from estate duty the deceased estate of a person who dies after Zimbabwe became an independent state in 1980 and who is designated a national hero of Zimbabwe in terms of the National Heroes Act, 1984 (Act No. 13 of 1984).

The Sales Tax Act (Chapter 184) was amended: on 1 April 1988 to increase the minimum figure of annual sales, at which a trade becomes obliged to register for sales tax purposes, from Z$ 50,000 to Z$ 100,000; on 1 August 1988 to exempt fresh fruit from sales tax; and on 25 November 1988 to allow refunds of sales tax on goods of a capital nature acquired for new projects approved by Government (and any duty on the importation of such goods is also refundable).

Government has announced that in order to provide a cushion against exchange rate fluctuations it will extend its exchange risk cover from 6 months to a period of 5 years at a premium of 5% per annum.

On 2 September 1988, 2 new double taxation agreements were published, one with the German Democratic Republic and the other with the Federal Republic of Germany.

As can be seen from the above, the 1988/89 tax year is a year of change for Zimbabwe and all of the changes have been welcomed, generally to a greater than to a lesser degree, by all of the taxpaying public.

APPENDIX A

	Single persons		Married persons		
	Tax payable (including surcharges 1987/88)		Taxable profit/Remuneration		
Taxable profit/Remuneration	1988/89	1987/88	Husband	Wife	Total or one wage earner
Z$	Z$	Z$	Z$	Z$	Z$
1,800	NIL	NIL	1,800	1,800	3,600
3,150	220	278	3,150	3,150	6,300
3,600	310	382	4,500	4,500	9,000
4,500	490	600	6,750	6,750	13,500
6,750	1,165	1,227	9,000	9,000	18,000
9,000	1,840	1,969	11,250	11,250	22,500
11,250	2,740	2,811	13,500	13,500	27,000
13,500	3,640	3,809	33,000	1,000	34,000
18,250	6,015	6,227	34,000	1,800	35,800
23,000	8,390	8,754	18,250	18,250	36,500
28,000	11,140	11,506	35,000	3,150	38,150
33,000	13,090	14,389	36,000	4,500	40,500
34,000	14,490	14,989	37,000	6,750	43,750
40,000	18,090	18,589	23,000	23,000	46,000
50,000	24,090	24,589	38,000	9,000	47,000
60,000	34,890	35,389	39,000	11,250	50,250
80,000	42,090	42,589	40,000	13,500	53,500
90,000	48,090	48,589	28,000	28,000	56,000
100,000	54,090	54,589	40,000	18,250	58,250
120,000	66,090	78,589	40,000	23,000	63,000
140,000	78,090	78,589	33,000	33,000	66,000
The tax shown in the schedules should be reduced as follows in respect of minor children. The reduction for 1987/88 has been calculated excluding all statements except the family taxpayer's abatement and allowing maximum relief for the surcharge.			34,000	34,000	68,000
			40,000	28,000	68,000
			40,000	40,000	80,000
			50,000	33,000	83,000
			57,000	33,000	90,000
			67,000	33,000	100,000
			87,000	33,000	120,000
			100,000	40,000	140,000

No. of children	1988/89	1987/88
1	120	128
2	240	261
3	360	405
4	480	560
5	600	720
6	720	896
More than 6	720	896

Tax payable (including surcharges 1987/88)				
Two-earner family 1988/89			One-earner family 1988/89	One or two family
Husband	Wife	Total		
Z$	Z$	Z$	Z$	Z$
Nil	Nil	Nil	Nil	110
220	220	440	670	690
490	490	980	1,480	1,449
1,165	1,165	2,330	3,280	3,082
1,840	1,840	3,680	5,530	5,197
2,740	2,740	5,480	7,780	7,567
3,640	3,640	7,280	10,230	9,995
13,090	Nil	13,890	14,130	13,970
14,490	Nil	14,490	15,210	15,040
6,015	6,015	12,030	15,630	15,460
15,090	220	15,310	16,620	16,450
15,690	490	16,180	10,030	17,860
16,290	1,165	17,455	19,980	19,810
8,390	8,390	16,780	21,330	21,160
16,890	1,840	18,750	21,930	21,760
17,490	2,740	20,230	23,880	23,710
18,090	3,640	21,730	25,850	25,660
11,140	11,140	22,280	27,330	27,160
18,090	6,015	24,105	28,680	28,510
18,090	8,390	26,480	31,530	31,360
13,890	13,890	27,780	33,330	33,160
14,490	14,490	28,980	34,530	34,360
18,090	11,140	29,230	34,530	34,360
18,090	18,090	36,180	41,730	41,560
24,090	13,890	37,980	43,530	43,360
28,290	13,890	42,180	47,730	47,560
34,290	13,890	48,180	53,730	53,560
46,290	13,890	60,180	65,730	65,560
54,090	18,090	72,180	77,730	77,560

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SINGAPORE:

New Tax Incentives

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INTRODUCTION

Various tax incentives have been introduced from time to time by the Singapore Government to stimulate the growth of the banking and financial services sector.

The normal rate of tax is 33%. However, a tax incentive in the form of a "concessionary" rate of tax of 10% on income derived from "offshore" loans was introduced for Asian Currency Units (ACUs) in the late 1970s. This incentive has since been extended to income derived by ACUs from other qualifying activities and to specified income of approved Fund Managers and Securities Companies. In addition, another tax incentive scheme exempts Income from Funds Managed for Foreign Investors from tax.

The incentive scheme is governed by Regulations issued by the Minister for Finance in exercise of the powers conferred upon him by Sec. 43A of the Income Tax Act (Cap. 134) ("the Act"). The purpose of the scheme is to encourage the further growth of the investment management industry and the Asian Dollar Market in Singapore.

The net qualifying income derived by the respective institutions less the 10% concessionary tax may be distributed to shareholders of the institutions in the form of exempt dividends. Where the shareholder is a holding company owning not less than 50% of the beneficial interest in the issued capital of the institution at the time such dividends are received, the holding company may in turn distribute the exempt dividends to its shareholders.

Recently, the Singapore Government also announced a concessionary rate of tax of 10% instead of the usual rate of 33% for approved Oil Traders and Future Contracts for Oil and Other Commodities.

I. THE INCOME TAX (CONCESSIONARY RATE OF TAX FOR ACU INCOME) REGULATIONS 1988

An ACU is a separate bookkeeping unit set up by a bank, under special licence, for Asian dollar transactions. Under the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations 1988[1], tax is payable at the rate of 10% on the income of the ACU of a financial institution derived from the following activities:

(a) loans in foreign currencies, other than bonds and debentures specified in para.(e); made to persons outside Singapore to be used outside Singapore where the interest on such loans is not borne, directly or indirectly, by a person resident in Singapore or by a permanent establishment in Singapore except in respect of any business carried on outside Singapore by a person resident in Singapore through a permanent establishment outside Singapore;
(b) opening, advising or confirming of letters of credit relating to offshore trade transactions;
(c) financing or re-financing of offshore trade transactions with or without letters of credit;
(d) transactions with banks or branch offices outside Singapore or with other ACUs in Singapore with regard to any of the following:
  (i) loans;
  (ii) placement of funds;
  (iii) bankers' acceptances on bills relating to offshore trade transactions;
  (iv) bills relating to offshore trade transactions; and
  (v) negotiable certificates of deposit:
  provided that the transactions are in foreign currencies;
(e) managing, underwriting or selling (as a member of a selling group) the following types of securities denominated in any foreign currency:
  (i) Asian dollar bonds approved by the Minister under Sec. 13(1)(v) of the Act;
  (ii) Asian dollar bonds and other bonds and debentures where the interest on such bonds and debentures is not borne, directly or indirectly, by a person resident in Singapore or by a per-

1. The full text was published in the Singapore Government Gazette, Subsidiary Legislation Supplement No. 44 on Friday, 14 September 1988.

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manent establishment in Singapore except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore;
(iii) fixed or floating rate notes and fixed or floating rate negotiable certificates of deposit issued by banks;

(f) transacting, broking and investing in securities specified in para.(e);
(g) providing advisory services relating to financial matters to persons outside Singapore;
(h) foreign exchange transactions in currencies, other than Singapore dollars, with banks or branch offices or other persons outside Singapore or with other ACUs in Singapore;
(i) transactions in gold bullion, gold futures or financial futures, in foreign currencies with –
(i) an ACU of another financial institution;
(ii) a member of the Singapore International Monetary Exchange ("SIMEX");
(iii) a person who is neither a resident of nor a permanent establishment in Singapore; or
(iv) a branch office outside Singapore of a company resident in Singapore;
(j) providing guarantees, performance bonds, standby letters of credit and services relating to remittance where –
(i) in the case of a guarantee, performance bond or standby letter of credit, the party on whose behalf as well as the party in whose favour the facility is issued is an ACU of a financial institution, or a person who is neither a resident of nor a permanent establishment in Singapore, or a permanent establishment outside Singapore of a person resident in Singapore in respect of any business carried on outside Singapore through that permanent establishment;
(ii) in the case of services relating to remittances, the person for whom as well as the person to whom the remittances are made is an ACU of a financial institution or is a person who is neither a resident of nor a permanent establishment in Singapore;
(k) services (including services as a broker, as a nominee or as a custodian) on behalf of a person who is neither a resident of nor a permanent establishment in Singapore in connection with transactions relating to –
(i) stock, shares, bonds and other securities, denominated in any foreign currency, issued by a company which is not incorporated in Singapore or Malaysia and which is not resident in Singapore;
(ii) negotiable certificates of deposit denominated in any foreign currency;
(iii) Asian dollar bonds;
(l) services relating to transactions involving interest rate or currency swaps, in currencies other than Singapore dollars; or with –
(i) an ACU of another financial institution;
(ii) a person who is neither a resident of nor a permanent establishment in Singapore; or
(iii) a branch office outside Singapore of a company resident in Singapore;
(m) the sale of stocks, shares, bonds and other securities (other than those specified in para.(e)) denominated in foreign currencies, issued by a company which is not incorporated in Singapore or Malaysia and which is not resident in Singapore to –
(i) a person who is neither a resident of nor a permanent establishment in Singapore;
(ii) another ACU of a financial institution;
(iii) an approved securities company; and
(n) managing the funds of a foreign investor for the purpose of any designated investment.

This incentive scheme shall apply to the fees and commissions derived by an ACU specially approved by the Minister or such person as he may appoint for that purpose and it shall not apply where a foreign investor whose funds are managed by an ACU –
(a) has a permanent establishment in Singapore (other than an approved ACU);
(b) carries on a business in Singapore; or
(c) beneficially owns more than 20% of the issued capital of any company incorporated in Singapore, unless approval is granted by the Minister or such person as he may appoint.

"Offshore trade transactions" means trade transactions where –
(a) neither the buyer nor the seller is a resident of Singapore or a permanent establishment in Singapore;
(b) the goods are not exported from or imported into Singapore except for transhipment; and
(c) the transactions are in foreign currencies.

II. THE INCOME TAX (CONCESSIONARY RATE OF TAX FOR APPROVED FUND MANAGERS) REGULATIONS 1988

Under the Income Tax (Concessionary Rate of Tax for Approved Fund Managers) Regulations 1988[2], tax is payable at the rate of 10% by an approved Fund Manager on its fees and commissions derived on or after 7 March 1986 from managing the funds of a foreign investor for the purpose of any designated investments.

"Designated investments" means –
(a) stocks and shares denominated in any foreign currency of companies not incorporated and not resident in Singapore;
(b) securities, other than stocks and shares, denominated in any foreign currency (including bonds, notes, certificates of deposit, treasury bills) issued by foreign governments, foreign banks outside Singapore and companies not incorporated and not resident in Singapore;
(c) futures contracts denominated in any foreign currency held in any futures exchange;

2. The full text was published in the Singapore Government Gazette, Subsidiary Legislation Supplement No. 42 on Friday, 2 September 1988.

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(d) any immovable property situated outside Singapore;
(e) certificates of deposit, notes and bonds issued by ACUs in Singapore;
(f) Asian dollar bonds approved under Sec. 13(1)(v) of the Act;
(g) deposits in Singapore with banks approved under Sec. 13(6) of the Act;
(h) foreign currency deposits with financial institutions outside Singapore;
(i) stocks, shares, bonds and other securities listed on the Stock Exchange of Singapore or on the Kuala Lumpur Stock Exchange and other stocks, shares, bonds and securities issued by companies incorporated and resident in Singapore;
(j) Singapore Government securities.

This incentive does not apply where a foreign investor –

(a) has a permanent establishment in Singapore (other than an approved Fund Manager);
(b) carries on business in Singapore; or
(c) beneficially owns more than 20% of the issued capital of any company incorporated in Singapore

unless approval is granted by the Minister or such person as he may appoint.

An approved Fund Manager is required to keep and maintain such records of particulars of foreign investors as may be required by the Minister.

III. THE INCOME TAX (CONCESSIONARY RATE OF TAX FOR APPROVED SECURITIES COMPANIES) REGULATIONS 1988

Under the Income Tax (Concessionary Rate of Tax for Approved Securities Companies) Regulations 1988[3], tax is payable at the rate of 10% on the income derived by an approved securities company from the following activities:

(a) services (including services as a broker, as a nominee or as a custodian) on behalf of a person who is neither a resident of nor a permanent establishment in Singapore in connection with transactions relating to –
  (i) stocks, shares, bonds and other securities, denominated in any foreign currency, issued by a company which is not incorporated in Singapore or Malaysia and which is not resident in Singapore;
  (ii) negotiable certificates of deposit denominated in any foreign currency;
  (iii) Asian dollar bonds;

  the 10% concessionary rate does not apply where the payments for the services are borne, directly or indirectly, by a person resident in Singapore or by a permanent establishment in Singapore of a non-resident person;
(b) the sale of stocks, shares, bonds and other securities referred to in para.(a) above to –
  (i) a person who is neither a resident of nor a permanent establishment in Singapore;
  (ii) an ACU of a financial institution;
  (iii) another approved securities company.

"Approved securities company" means a company which is approved by the Minister or such person as he may appoint under Sec. 43A(1)(c) of the Act.

IV. THE INCOME TAX (INCOME FROM FUNDS MANAGED FOR FOREIGN INVESTORS) REGULATIONS 1988

The tax exemption scheme for offshore fund management was extended by the 1986 Budget to include certain investments in Singapore's domestic markets and the participation of non-ACU approved fund managers.

The Income Tax (Income from Funds Managed for Foreign Investors) Regulations 1988[4] provides that specified income derived by a foreign investor in respect of designated investments from funds managed by an ACU or other approved fund manager is exempt from income tax. The Regulations have legal effect as a result of a non-resident having his funds managed in Singapore.

"Designated investments" means:

(a) stocks and shares denominated in any foreign currency of companies not incorporated and not resident in Singapore, excluding stocks and shares of companies incorporated in Malaysia which are listed on the Stock Exchange of Singapore or on the Kuala Lumpur Stock Exchange;
(b) securities (other than stocks and shares) denominated in any foreign currency including bonds, notes, certificates of deposit, treasury bills issued by foreign governments, foreign banks outside Singapore and companies not incorporated and not resident in Singapore;
(c) futures contracts denominated in any foreign currency held in any futures exchange;
(d) any immovable property situated outside Singapore;
(e) certificates of deposit, notes and bonds issued by ACUs in Singapore;
(f) Asian dollar bonds approved under Sec. 13(1)(v) of the Act;
(g) deposits in Singapore with banks approved under Sec. 13(6) of the Act;
(h) foreign currency deposits with financial institutions outside Singapore;
(i) stocks, shares, bonds and other securities listed on the Stock Exchange of Singapore or on the Kuala Lumpur Stock Exchange and other stocks, shares, bonds and securities issued by companies incorporated and resident in Singapore;
(j) Singapore Government securities.

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3. These Regulations, effective from 16 September 1988, were published in the Singapore Government Gazette, Subsidiary Legislation Supplement No. 44 on Friday, 16 September 1988.
4. These Regulations were published in the Singapore Government Gazette, Subsidiary Legislation Supplement No. 42 on Friday, 2 September 1988.

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33rd Congress of the International Union of Lawyers 27-31 August 1989 in Interlaken/Switzerland

The 33rd Congress of the Union Internationale des Avocats (UIA) will take place 27-31 August 1989 in Interlaken, a beautiful resort area in the Bernese Oberland in Switzerland. This event will gather a great number of distinguished lawyers from all over the world. Here are some of the highlights of the programme:

- New Trends in Torts (including Product Liability and Pollution Claims)
  Chairman: Ian Hunter, Q.C., London/U.K.
- Recent Developments in Transnational Banking and Securities Laws (including Banking Secrecy, International Legal Co-operation, Insider Trading etc)
  Chairman: Georg Friedli, Berne/Switzerland
- Legal Protection of the Right to be Different (the European Court and the Protection Against Discrimination, Freedom of Expression etc.)
  Chairman: Albert-Louis Dupont-Willemin, Geneva/Switzerland

Besides the main topics, other issues will be dealt with by various workshops and commissions, such as: Regulation on Take-Over-Bids, Sports Law, Reproductive Medicine and Genetic Engineering, EEC and Intellectual Property Rights, Secrecy Laws and Blocking Statutes vs. International Legal Co-operation.

Details are available at request from Dr. Franz Kellerhals, P.O. Box 1761, CH-3001 Berne/Switzerland (Telefax +41 31 211 393).

This incentive scheme does not apply where a foreign investor –
(a) has a permanent establishment in Singapore (other than an approved fund manager);
(b) carries on a business in Singapore; or
(c) beneficially owns more than 20% of the issued capital of any company incorporated in Singapore

unless approval is granted by the Minister or such person as he may appoint.

V. TAX INCENTIVES FOR APPROVED OIL TRADERS

The 10% concessionary rate of tax incentive scheme will be extended to approved oil traders with effect from 1 January 1989. This incentive scheme will be administered by the Trade Development Board and is intended to encourage international oil trading companies to have their regional operations in Singapore. To qualify as an approved oil trader, a company must:
(a) be an established international oil trading company with world-wide network and good track record;
(b) have direct total business spending in Singapore of at least S$ 500,000 a year;
(c) employ at least 3 experienced oil trading professionals;
(d) have an annual turnover in Singapore of at least US$ 100 million.

Other factors which will be taken into account are whether the company:
(a) has substantial capital funds;
(b) will contribute to the success of the oil futures market, e.g. by being a member of SIMEX or by committing to trade actively in SIMEX;
(c) has made a commitment to use Singapore as a centre of arbitration in case of disputes in its international trade;
(d) has made a commitment to use Singapore's banking and other ancillary services.

Qualifying income of approved oil traders in respect of transactions with non-residents or other approved oil traders will be taxed at a concessionary rate of 10% under this incentive scheme. Qualifying income includes income derived from various aspects of oil trading, such as trading in physicals, commissions from broking activities in physicals and profits from trading in oil futures.

The qualifying types of oil in connection with this incentive scheme are crude oil and its refined products such as gasoline, kerosene, naptha, gas oil, heating oil, diesel, fuel oil and low sulphur waxy residue.

VI. TAX INCENTIVES FOR OIL FUTURES CONTRACTS

A 10% concessionary rate of tax on profits from oil futures contracts trading will apply to a new fuel oil futures contract. To launch oil futures contracts (probably in mid-January 1989), SIMEX will introduce 2 new categories of membership to attract participants from the oil industry. The new categories proposed are:
(a) Commercial Associate Members for companies wishing only to participate in the oil futures on SIMEX.
(b) Trading permit holders for individuals wishing to be floor traders on SIMEX in oil futures.

VII. TAX INCENTIVES FOR OTHER COMMODITIES

The Singapore Government has announced that it intends to extend the new incentives granted to the oil industry to trading in other commodities. According to information available to date, coffee trading may be the next to enjoy tax concessions as there are more than 40 coffee traders in Singapore.

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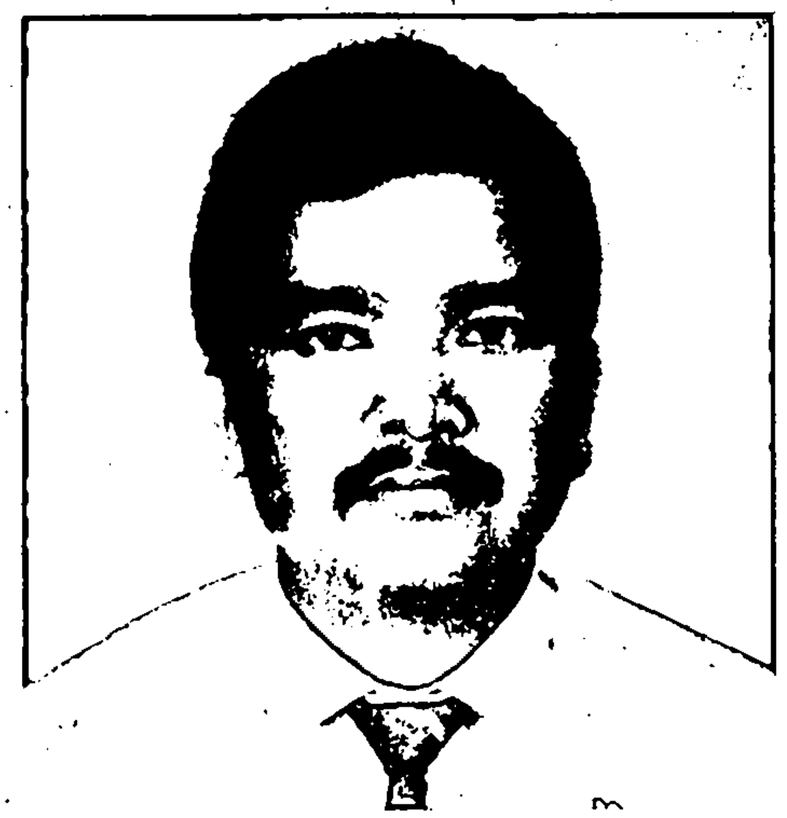
NEPAL:

A Survey of the Tax System

Rup Bahadur Khadka



Rup Bahadur Khadka, born in Achham, Nepal, received a Master's Degree in Economics with "Merit" from Tribhuran University, Nepal and earned a Master's of Philosophy from Gokhle Institute of Politics and Economics, Poona University, India. Mr. Khadka is the author of several books and articles. He was a member of the Task Force on Local Taxation appointed by His Majesty's Government of Nepal. Mr. Khadka, a Research and Curriculum Development Officer in the Revenue Administration Training Centre, Ministry of Finance, Nepal, is currently a Fellow at the IBFD.

TAX SYSTEM DURING THE RANA REGIME[1]

Very little is known about the tax system that existed in Nepal before the 1950s. The country was under the autocratic *Rana* rule for a period of slightly more than a century (1846-1951). During that period, practically speaking, there was no difference between Government revenue and the private money of the ruling Prime Minister. Revenue was generated mainly through land revenue, excise and customs duties. Excise duties were imposed on liquor, leather, pig hair, mining, herbs, hashish and opium[2] while customs revenue was collected not only on goods that crossed national boundaries but also on goods that crossed some sort of administrative boundaries.[3]

The above taxes were governed by various *sanad sawals* (tax laws) prepared for a particular area. Consequently, different systems of levying, assessing and collecting taxes applied in different parts of the country. The taxes were collected by middlemen. Land revenue was collected through *Mukhiya* and *Zimwal* in the hilly area and *Zamindar* and *Patwari* in the Terai.[4] The middlemen maintained records of all cultivators residing in their respective areas, collected land tax every year and deposited it in the Government treasury. The collection of land revenue by these middlemen became well-established over the years. Customs duties and excises, however, were collected by contractors. A licence for collection of customs and excise duties in a particular area was generally granted by auction to the highest bidder for a specified period of time.

The reasons underlying introduction of the middleman system of tax collection perhaps lay in the fact that the *Rana* rulers did not want to be involved in revenue administration but wanted to collect the maximum revenue with the minimum effort. Moreover, because of the lack of adequate revenue personnel, it was impossible to have an effective tax administration and to collect tax revenue directly..

The middleman system did offer some advantages: the Government knew in advance the approximate amount of revenue that would be received during a given period of time; the Government was not involved in tax collection so few persons were needed for tax administration resulting in smaller administrative costs; and because the middlemen were granted positions of power and prestige (such as *Mukhiya, Zamindar, Laptan, Dittha*),[5] they acted efficiently to maintain their positions. As revenue agents, they assumed leadership responsibilities and involved themselves in the social and development activities of their respective areas.

The system of collecting tax revenue through the middlemen, however, suffered from a number of drawbacks. The possibility loomed large that the middlemen collected more tax revenue than legally required so a portion of money paid by taxpayers went in the pockets of the middlemen rather than to the public exchequer. Authority to collect tax was granted to many middlemen so methods of collection differed. The collection of land revenue through middlemen became a source of exploitation as landowners were forced to pay not only the land revenue but they also had to offer gifts in the form of *walak, salami* or *Beth-begar,*[6] to their respective *Mukhiya, Zamindar, Zimwal* or *Patwari.*

1. The *Rana* family held power and established a hereditary Prime Minister for 104 years beginning in 1846. This era is known as the *Rana* regime.
2. *An Introduction to Excises,* HMG, Ministry of Finance, Excise Department, Kathmandu, 1976 at 2.
3. R.B. Khadka, "Development of Customs Duties in Nepal", *Upahar,* Vols. 2-3, 1985 at 7.
4. A *Mukhiya* is a chief of an area; a *Zimwal* is one who is responsible for a village; a *Zamindar* is a landlord; and a *Patwari* is an honorary village registrar and accountant.
5. A *Laptan* is an honorary lieutenant and a *Dittha* is an honorary clerk.

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DEVELOPMENT OF THE TAX SYSTEM SINCE THE 1950S

Nepal took a new direction when the *Rana* regime ended in 1951. The new Government intended to undertake various development activities. A national budget was prepared and legislated for the first time in 1951. An attempt was made to abolish the contract system of collecting tax revenue because of its inherent limitations. It was felt necessary to introduce new taxes, including income tax, and to rationalize the then-existing taxes. Commencement of the planned development process further necessitated broadening the tax base to generate more revenue in order to finance development activities. Because of political instability, however, no significant progress could be made until 1958. The practices prevailing under the *Rana* regime continued to influence the tax system even after the regime terminated. For example, the different methods of assessing and collecting taxes in different parts of the country remained as they were before the 1950s. Such a system, however, was neither rational nor logical.

To establish uniformity in the tax system throughout the country, the Excise Act 1958 and the Customs Act 1962 were enacted and all other existing rules and regulations (*sanad sawal*) concerning excise and customs duties were abolished. Excise duties were initially imposed on industrial production such as sugar and matches and have since been extended to various other commodities.[7]

The introduction of income tax in fiscal year 1959/60 was a breakthrough in the Nepalese tax system. The tax was levied on business income and salaries[8] by the Finance Act 1959 and later implemented under the Business Profits and Salaries Act 1960. The base of income tax was broadened in the Income Tax Act 1962 which replaced the Business Profits and Salaries Act 1960. Under the 1962 law, income tax was levied on income derived from business, vocation, investment, rent, employment, profession and income from any other source. The 1962 Act was later replaced by the Income Tax Act 1974. This Act, as amended in 1977, 1979, 1980, 1984, 1985 and 1986, contains the current statutory framework for imposition and collection of income tax.

Foreign investment and urban house and land taxes were adopted in fiscal year 1959/60. The foreign investment tax, which was levied on investments made by Nepalese residents abroad, was intended to discourage the flight of capital from Nepal. However, because the tax was extremely difficult to administer and not revenue-productive, the tax was merged into the income tax in fiscal year 1969/70. The urban house and land tax, imposed on houses and land in urban areas as specified by His Majesty's Government (hereinafter referred to as HMG), was levied initially only in large cities. It was later extended to other urban areas as well.

Entertainment tax was codified in 1961[9] by the Entertainment Tax Act 1961. This tax is levied on all entrance fees charged for admission into a place of entertainment. Air flight tax and hotel tax were included in the Nepalese tax family in fiscal year 1961/62. The former tax, collected from each passenger, was initially levied on passengers of international flights. In fiscal year 1974/75, it was extended to include passengers of domestic flights. Hotel tax, which is levied on the invoices of the hotel, was abolished in fiscal year 1964/65 in order to promote the tourist industry and increase foreign exchange earnings but it was reintroduced in fiscal year 1967/68. The rates of this tax have been graduated according to the standard of the hotel since fiscal year 1980/81.

Stamp duties were levied on certain types of documents dealing with the transfer of immovable property, business transactions, etc. in fiscal year 1962/63 but they were abolished in fiscal year 1974/75 probably due to low revenue productivity. Stamp duties were reinstated in fiscal year 1985/86 but repealed after one year as they could not be implemented successfully.

Like stamp duties, the history of house rent tax is also tumultuous. This tax was introduced as an independent tax on house rent in fiscal year 1965/66. However, house rent was included in the income tax base and house rent tax was abolished in fiscal year 1969/70. House rent was again split off from income and house rent tax was levied as an independent tax in fiscal year 1974/75. Since there was little reasoning (if any) in levying house rent tax separately, the rent was incorporated in income for income tax purposes; this tax was revoked in fiscal year 1978/79.

A contract tax was adopted in fiscal year 1965/66. This tax is withheld at the time of each payment of the contract amount.

The introduction of a (basically) retail level sales tax in 1965 brought many retailers into the tax net. However, most retailers were small, unorganized, temporary, seasonal, without a permanent place of doing business, illiterate and so on. Some retailers were not registered, some registered taxpayers did not submit sales tax returns to the tax office, some did not issue bills to the customers and some under-billed customers. It was difficult for the weak tax administration to keep track of retailers for tax purposes so the tax was shifted from retail level to wholesale level in 1968. Theoretically, the wholesale level is a convenient levying point because there are fewer wholesalers and they are more organized, which simplifies tax administra-

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6. *Walak* is a kind of gift; *salami* is a present to a superior; and *Beth-begar* is a compulsory service rendered without remuneration.
7. See R.B. Khadka, "Development of Excise Taxation in Nepal", Nepal Bank Patrika, No. 171, 1985 at 14-17.
8. A certain percentage was deducted from the salaries of Government employees as *salami* during the *Rana* regime. The Nepalese peoples' unfamiliarity with this type of tax and the lack of adequate effective tax administration may account for the choice of such a narrow base of income tax: Prima facie, imposition of income tax on business income and salaries is relatively easier than other sources of income.
9. This tax was enacted for the first time in 1949/50 and was collected by customs administration until 1960/61. See S.K. Singh, *The Fiscal System of Nepal,* Ratna Pustak Bhandar, Kathmandu, 1977 at 259.

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tion procedures. In Nepal, however, no clear-cut distinction can be made between wholesalers and retailers because the wholesalers are also small and unorganized and, like retailers, they do not maintain accounts. Despite this, no attempt was made to strengthen administration. The problems associated with the failure to issue bills, under-billing practices and listing imports in the name of bogus firms became more acute. The wholesale level tax was, therefore, shifted to the import-manufacturing level in 1974. Since 1974 the tax has been levied and collected at the customs points on imports; on domestic products, it is levied on the sales of manufacturers.[10]

Many other taxes were included in the Nepalese tax family over the years. For example, road cess and vehicle tax were introduced in fiscal years 1971/72 and 1972/73, respectively. Taxes on interest and loans were adopted in fiscal year 1977/78. Road cess was initially levied on vehicles on the basis of per kilometre of road but this system was complicated so in fiscal year 1972/73, a lump-sum tax was imposed based on the length of various roads. Because the road cess was collected at several points, it hindered traffic; the tax was abolished in fiscal year 1979/80.

Loan tax was imposed on bank loans and levied on both lenders and borrowers. Lenders paid 0.25% and borrowers paid 0.50% of the total amount of the loan. The tax was deducted by the bank at the time the loan was made and deposited in the Government revenue account. However, loans directed to the priority sector (e.g. agriculture, a cottage industry, etc.) and loans having gold and silver as security were exempt from the tax. The stated rationale underlying introduction of this tax was to control credit, considering the unwarranted rise in the money supply. Collection of the loan tax increased the administrative burden of the banks, so in fiscal year 1978/79 a 7.5% tax on the total amount of interest earned by the bank from the loan was imposed. This tax, however, was incompatible with the growing Nepalese economy where it was necessary to expand banking activities and investment. The 7.5% levy was abolished in fiscal year 1980/81.

Panchayat development and land tax, essentially a local tax, was introduced on a trial basis in fiscal year 1977/78. This tax was levied on the land and was tied to the yield of the main crop. The tax was collected from both landowners and land tenants and was intended primarily to mobilize resources for the local authorities in order to finance local development activities. However, 35% of the collected revenue had to be allocated to the HMG. Due to poor administration and unscientific assessment and collection procedures, the tax was unpopular among the local people and eventually suspended in fiscal year 1979/80.

Other taxes which were introduced in Nepal include the local development tax and the video tax (1980/81), *Bhumi* (land) tax on urban areas (1981/82) and the road bridge maintenance tax (1982/83). These taxes remain in effect today. A house construction tax, which was levied on the construction of houses in urban areas, was adopted in 1983/84. However, the tax failed to yield the expected revenue and it was felt that town panchayats (municipalities) were the appropriate authorities to levy such a tax, so it was abolished in fiscal year 1985/86. The last addition in the Nepalese tax structure were the countervailing duties and television tax introduced in fiscal year 1987/88.[11] The former taxes imported goods in a similar manner to their domestically-produced counterparts while the latter is levied on both black and white and colour televisions.

There is no capital gains tax, gift tax, inheritance tax or net wealth tax in Nepal.

THE EXISTING TAX STRUCTURE

The above discussion of the development of the Nepalese tax system shows that many taxes have been introduced since the mid-1950s. The base of some of these taxes has broadened while others have been abolished. The current structure of the Nepalese tax system is as follows:

Table I

Taxes	Revenue collection in 1986/87	
	Amount (Rs. in million)	Percentage
Customs duties	1506	34.45
Sales tax	1144	26.17
Excise duties	679	15.53
Income tax	437	10.00
House and land registration fees	212	4.85
Contract tax	126	2.88
Land revenue	72	1.65
Hotel tax	66	1.51
Air flight tax	45	1.03
Entertainment tax	27	0.62
Vehicle tax	23	0.53
Urban house and land tax	13	0.30
Road bridge maintenance tax	11	0.25
Tax on interest	10	0.23
Total	4371	100.00

Source: Budget Speech 1988/89

Customs duties

Customs duties, comprised of import and export duties, are the major source of Government revenue in Nepal. As shown in Table I, these duties provided 34.45% of total tax revenue collected in fiscal year 1986/87.

Import duties, which provide about 95% of total customs revenue, are levied mainly on the import of consumer goods. Raw materials and capital goods are either exempt or taxed lightly. Indian excise refund is

10. See R.B. Khadka, "Development of Sales Taxation in Nepal", *Nepal Bank Patrika*, No. 164, 1985 at 15-19.
11. The video tax of 1980/81 and the television tax are now combined.

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included in the import duties.[12] Export duties, levied mainly on agricultural products, metallic ores, raw hides and skin, leather, timber, etc., are not revenue earners of any significance.

The base of the import duties is the c.i.f. price of imports. This value is, as far as possible, determined and reviewed every 6 months by a central valuation committee for goods imported from countries other than India and every 3 months by the regional valuation committees of the customs officers for goods imported from India.

The rates of customs duties are fixed annually by the Finance Act. Customs rates are expressed largely on an ad valorem basis, with a few exceptions. There are 9 basic customs rates, ranging from 5% to 100%.[13] Some items like liquor and cigarettes are subject to a rate higher than 100%. Additional customs rates are also levied.[14] However, additional customs rates are not levied on goods produced in China and India and imported into Nepal if the basic customs rate is less than 50%.

Sales tax

Sales tax is the second largest source of Government revenue. This tax accounted for 26.17% of the total tax revenue in fiscal year 1986/87. The tax is levied on a wide range of domestic and imported goods. The only services subject to sales tax are telecommunications.

The tax is imposed at the point of import-manufacturing. The Customs Administration collects the tax on taxable imported goods; the sales tax is collected at the time of sale by the manufacturer in the case of domestic products. The base of sales tax for imports is the sum of the import value determined for purposes of customs duties, import duties and the countervailing duties. The base for domestic products is the total of ex-factory price and excise duties.

Four rates of sales tax ranging from 5% to 20% are levied.[15]

Excise duties

Excise duties contribute about 16% to total tax revenue. It is levied on manufactured domestic products and collected from manufacturers. Although there are approximately 50 taxable items, the bulk of excise tax revenue comes from a limited number of items such as tobacco products, alcoholic beverages, nylon and synthetic cloth, cement, sugar, timber and soft drinks. Cigarettes alone provide about half of the excise revenue.

The base of excise duties is the volume of production or ex-factory price which includes the cost of production and profit of the manufacturers, depending upon the excise rates. Rates are generally fixed on a specific or on an ad valorem basis although for certain items the rates are fixed on both a specific and an ad valorem basis and the higher rate is the effective rate. In other cases, both specific and ad valorem rates are levied. The rates vary considerably from commodity to commodity.

Income tax

Income tax forms about 10% of the total tax revenue. Both residents and non-residents of Nepal are subject to income tax.[16] Income tax is levied on income of residents arising in or derived from Nepal and on income earned or acquired abroad which is remitted to Nepal. With respect to non-residents, income tax is levied on income earned or acquired in Nepal.[17] The sources of income are enumerated as:

(a) agriculture;[18]
(b) industry, business, profession or vocation;
(c) remuneration;
(d) building and land rent; and
(e) other sources of income.

Income tax is levied on a preceding year basis. The tax base is the net income from each source, calculated after deducting allowable expenses incurred in earning the income.

Income tax rates for individuals, couples or families and partnerships, private limited companies, corporations and temporary residents are progressive, ranging from 10% to 50%. The maximum rate for salaries, however, is 40%. Public companies listed with the Security Exchange Centre and Government companies are subject to a 40% flat rate corporate income tax.

House and land registration fees

Currently house and land registration tax is in fifth position regarding its revenue contribution. This tax provided about 5% of the total tax revenue in fiscal year 1986/87. Registration fees are imposed in connection with the transfer, mortgage, leasing, gifts, endowments, etc. of immovable property. The base of the fees is the value of the property concerned. Registra-

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12. Indian central excise duty, levied on Indian products which are imported into Nepal under the duty-refundable procedure, is refunded by the Indian Government to HMG, Nepal according to the customs agreement of 1953 between India and Nepal (as modified from time to time). Such imports, directly imported from Indian factories under Application For Removal of Goods Form No. 1 (commonly known as AR1 Form), are not subject to any tax except central excise duty in India. Indian central excise duty levied on such items is refunded by the Indian Government to HMG Nepal upon proof of importation into Nepal.
13. The rates are 5, 10, 15, 20, 25, 30, 50, 70 and 100%.
14. The rate is 25% for items subject to 5 and 10% basic customs duties; 35% for items subject to 15 and 20%; 45% for items subject to 25 and 30%; and 55% on items subject to basic customs duties of 50% or above. Synthetic textiles and ready-made garments are subject to 100% additional customs rates.
15. The rates are 5, 10, 15 and 20%.
16. A non-resident individual is one who has stayed in Nepal for 180 days or less in any fiscal year. A non-resident company is a foreign firm whose management or control is exercised abroad.
17. Income Tax Act 1974, Art. 6.
18. In practice, however, agricultural income has remained outside the purview of income tax.

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tion fees for gifts and endowments are lower than the fees for other transfers.

Contract tax

Contract tax constituted 2.88% of the total tax revenue in fiscal year 1986/87. This tax is levied at the rate of 5% on the value of contracts exceeding 10,000 Rs. which are negotiated with the Government or other parties for undertaking work in Nepal for a profit. The tax is withheld at the time of each payment by the party awarding the contract.

Land revenue

Land revenue, the oldest tax in Nepal, provides less than 2% of the total tax revenue at present. This tax is levied on land and the rates are fixed on the basis of specific units of area. The unit is *Bigha* (1 *Bigha* = 1.6 acre) in the Terai region and *Ropani* (1 *Ropani* = 0.12 acre) in other regions. The land is divided into 4 categories for purposes of the land revenue: *Abal, Doyam, Seem* and *Chahar.*[19]

In fiscal year 1981/82, a separate land tax was introduced on land situated in urban areas. The new tax is known as *Bhumi Kar* and it replaced the traditional land revenue. The land in urban areas (town Panchayats) is divided into 6 groups and different rates are fixed for each group. The rates of *Bhumi Kar* vary for the land of Kathmandu valley, the Hilly region and the Terai region.

In addition to the above-mentioned taxes based on land, a local development tax is levied at the rate of 10% of the total amount of the land tax or *Bhumi Kar.*

Hotel tax

Hotel tax provided 1.51% of the total tax revenue in fiscal year 1986/87. This tax is levied on the total bill payable by the customer to the hotel. Tax rates are linked to the class of hotel, i.e. 10% for ordinary hotels, 12% for one and 2 star hotels, and 13, 14 and 15% for 3, 4 and 5 star hotels, respectively.

Air flight tax

Air flight tax forms about 1% of the total tax revenue. This tax is levied on passengers who embark on a domestic or international flight from an airport in Nepal. Existing rates of tax are 200 Rs. on passengers of international flights and 10, 20 and 30 Rs. on passengers of domestic flights, depending upon the point of embarkation.

Other taxes

The remaining taxes do not earn significant amounts of revenue. These taxes include entertainment tax, vehicle tax, urban house and land tax, road bridge maintenance tax and tax on interest, which contributed 0.62%, 0.53%, 0.30%, 0.25% and 0.23%, respectively, to the total tax revenue in 1986/87.

Entertainment tax is levied on the per ticket basis for admission to any place of entertainment (cinemas, dance halls, opera, theatres, circuses, etc.) Tax rates are graduated according to the class of ticket.

Vehicle tax is levied on all types of vehicles such as cars, jeeps, vans, buses, trucks, minibuses, three-wheelers, motor cycles, etc. and is collected from the vehicle owner. Tax rates are levied on the basis of per vehicle which are further linked to the capacity of vehicles other than trucks, buses, minibuses and three-wheelers.

Urban house and land tax is levied on houses and adjacent compounds in urban areas. The area is prescribed by Government Gazette notification. However, undeveloped blocks of land located in urban areas are not brought into the tax net. The base of the tax is the aggregate value of the urban house and land property. The value of the house for purposes of this tax is linked to the average cost of the building, zonal importance, road importance, rate of depreciation and the year of construction. The rate of this tax is 100 Rs. for the first taxable value of 500,000 Rs. and thereafter 4 progressive rates (i.e. 0.15%, 0.50%, 1% and 2%) are levied on the higher values.

Interest tax is levied on interest income exceeding 5,000 Rs. of a depositor earned from a fixed deposit with a commercial bank. The tax is withheld by the bank at the time the interest is paid at a rate of 5% and it is deposited in the account of the concerned tax office. This tax is credited against the income tax payable on the total income, including interest from fixed deposits.

Road bridge maintenance tax is collected at the customs point on imports of high-speed diesel and petrol to be used for vehicles at the rate of 20 paisa per litre.[20]

Television and video tax and countervailing duties are 2 comparatively new members of the Nepalese tax family. The former tax is levied at the annual rate of 100 and 300 Rs. on black and white televisions and colour televisions, respectively, and 600 Rs. on video recorders. Countervailing duties are levied on imported goods in a similar way as their domestic counterparts subject to excise duties.

CONCLUSION

Land revenue, customs duties and excises were used intensively during the *Rana* regime for revenue purposes and were collected by middlemen. When the *Rana* regime ended in 1951, an attempt was made to rationalize the then-existing taxes and to introduce new taxes. However, no significant progress could be made until the late 1950s, primarily as a result of

19. The categorization is made primarily on the basis of the nature of the soil and its fertility.
20. 100 paisa = 1 Rp.

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political instability. The introduction of modern direct taxes such as income tax, foreign investment and urban house and land tax in fiscal year 1959/60 was a benchmark in the evolution of the Nepalese tax system.

Since the 1960s, several taxes have been introduced to generate the revenue required for financing increasing Government expenditure. Overall results, however, have not been encouraging. As some of the taxes generated little revenue, they were abolished, only to be reinstated and later repealed again for the same reason. Nepal lacks a long-term tax planning strategy. Many tax measures have been introduced on an ad hoc basis without a careful consideration of revenue yield, operational aspects and probable economic effects.

From the existing taxes, revenue is largely generated from a few commodity-based taxes, i.e. customs duties, the import-manufacturing level sales tax and excise duties. These 3 taxes provide more than 75% of the total tax revenue. Customs tax alone provides more than one third of the total tax revenue. Income tax provides about 10% while property-based taxes, such as land revenue, house and land registration fees, urban house and land tax provide less than 7% of the total tax revenue. Other taxes based on services, such as contract tax, hotel tax, air flight tax, entertainment tax, etc. constitute about 8% of the total tax revenue. A large portion of revenue comes from a few taxes while other taxes are not only insignificant from the revenue point of view, but they also fail to effectively serve any socio-economic objective.

Tax revenue is largely based on commodity taxes meaning that the tax system is regressive because commodity taxes cannot be linked effectively to taxable capacity vis-à-vis taxes based on income and property. A large part of the revenue is collected at source, i.e. at the import-manufacturing level. The farther the tax is from the retail level the less productive, efficient and inequitable it becomes.

The bulk of the revenue comes from imports. However, since imports depend, inter alia, on external factors such as international relations, etc., it is not desirable to rely heavily on import-based revenue for a long period of time. Income tax and property-based taxes, traditionally known as direct taxes, have not been playing any significant role in the Nepalese fiscal system. Since these taxes are effective measures to achieve the goals of fiscal policy, including distribution, they need to be revamped significantly.

IFA NEWS

BRITISH BRANCH

The subject of the 14 February 1989 meeting was "Controlled Foreign Companies – How the Law is Operating".

The upcoming March meeting (to be held 21 March 1989) will consider the substantial amendments to the Japanese tax system. Professor Yuichiro Hiraishi from Kokushi-Kan University in Tokyo will address the British Branch on this subject.

JOINT SEMINAR OF THE U.S. AND BRITISH BRANCHES PRIOR TO THE RIO CONGRESS

A joint seminar between the U.S. and British Branches of IFA will be held on 7 and 8 September 1989 at the Biltmore Hotel in Miami, Florida. Full details of the programme, the cost and booking details will be sent to IFA members.

IFA REGIONAL CONGRESS – HONG KONG

The Hong Kong Branch of IFA will host the second IFA Regional Congress in the Hong Kong Convention Centre on 22, 23 and 24 November 1989. The 3 main topics for this congress will be:
1. The basic law of Hong Kong and its impact on Hong Kong's tax policies beyond 1997.
2. An examination of the tax policies of Hong Kong, Korea, Singapore, Taiwan and Thailand and how these policies have contributed to their economic success.
3. The transfer pricing policies of Japan and the People's Republic of China.

Further details of the Hong Kong Congress can be obtained from:

I.W. Harris
Secretary
International Fiscal Association
Hong Kong Branch
c/o Group Tax Department
Hong Kong Bank Group
GPO Box 64
Hong Kong

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 50-52 of the January 1989 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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La réglementation fiscale IT 2437 prévoit les différentes dispositions et les critères généraux à appliquer pour savoir si l'impôt étranger peut être imputé selon le système général d'imputation des impôts étrangers. La réglementation contient une liste des impôts étrangers considérés comme imputables. La réglemenation fiscale IT 2507, reproduite ici, est une mise à jour des impôts considérés comme imputables.

Australien: Die Steuerrichtlinie IT 2507: Das Anrechnungssystem für ausländische Steuern: Ausländische Steuern, welche für die Anrechnung auf australische Steuern vom Einkommen berücksichtigt werden 157
Die Steuerrichtlinie IT 2437 beschreibt die zutreffenden Gesetzesbestimmungen und die allgemeinen Kriterien, um festzustellen, ob eine ausländische Steuer unter dem allgemeinen Anrechnungsverfahren auf die australische Steuer angerechnet werden kann. Die Richtlinie enthält eine Liste von ausländischen Steuern, die als anrechenbar betrachtet werden. Die Steuerrichtlinie 2507, welche in diesem Heft abgedruckt wird, bringt die Liste von anrechenbaren Steuern auf den neuesten Stand.

Société comptable Seihwa:

Corée: Réforme fiscale 161
Le Gouvernement coréen a promulgué le 28 décembre 1988 une réforme fiscale comprenant 8 lois fiscales ainsi que des décrets. Parmi les modifications il faut noter l'introduction du système des prix de transfert, une modification de la définition du terme "établissement stable" et une simplification de la structure du taux de l'impôt sur le revenu des personnes physiques. Cet article résume plusieurs de ces modifications.

Seihwa Accounting Corporation:

Korea: Steuerreform 161
Die koreanische Regierung verabschiedete am 26. Dezember 1988 eine Reform der 8 koreanischen Gesetze und presidentiellen Beschlüsse. Die Änderungen betreffen u.a. die Einführung eines Verrechnungspreisesystems, die Änderung der Betriebstättendefinition und die Vereinfachung der Struktur von Einkommensteuersätzen. Dieser Artikel bietet eine kurze Beschreibung der verschiedenen Änderungen.

Har Govind:

Inde: Application de la loi indienne à l'industrie informatique 166
Le Gouvernement indien a annoncé au cours des quatre dernières années plusieurs politiques à suivre afin de promouvoir le développement de l'informatique aussi bien dans une application nationale que pour l'exportation. L'auteur démontre comment différentes dispositions de la loi indienne peuvent être utilisées en électronique et/ou dans l'industrie exportatrice.

Har Govind:

Indien: Die Anwendung der indischen Gesetze auf die Komputerindustrie 166
Die indische Regierung hat während der letzten 4 Jahre eine Anzahl von Plänen bekanntgegeben, dessen Ziel die Entwicklung von Komputersoftware sowohl für Inlandsbenutzung als auch für den Export war. Der Autor beschreibt, wie die verschiedenen indischen Gesetzesbestimmungen bei der Herstellung von Komputern und/oder bei der Exportproduktion von Komputern angewandt werden können.

Arthur Fisher et KPMG, Centre Fiscal International d'Amsterdam:

Etats-Unis: Investissements réalisés aux Etats-Unis: résumé de la loi fiscale de 1988 consacrée aux problèmes techniques et divers et de la Section 482 du "White Paper" (= Rapport officiel du Gouvernement) 173
Au cours de ces derniers mois, deux événements d'un intérêt primordial pour les contribuables ont eu lieu aux Etats-Unis. La loi fiscale de 1988 consacrée aux problèmes techniques et divers, qui modifie et clarifie certaines dispositions de la loi sur la réforme fiscale de 1986, est entrée en vigueur le 10 novembre 1988 et le 18 octobre 1988 l'Administration Fiscale a publié le "White Paper" sur les prix de transfert. Cet article résume certaines dispositions fiscales internationales de première importance qui se trouvent dans cette loi fiscale ainsi qu'un certain nombre de concepts sur les prix de transfert.

Arthur Fisher and KPMG, International Tax Centre, Amsterdam:

U.S.A.: Investitionen in den U.S.A.: Ein Überblick des „Technical and Miscellaneous Revenue Act of 1988" und des Paragraphen 482 des „White Paper" 173
Es gab in den letzten Monaten in den U.S.A. zwei Ereignisse, die von ausserordentlicher Bedeutung waren. Der „Technical and Miscellaneous Revenue Act of 1988" (TAMRA) änderte und erklärte eine Anzahl von Bestimmungen des „Tax Reform Act of 1986" und wurde am 10. November 1988 verabschiedet. Daneben veröffentlichten die amerikanischen Steuerbehörden am 18. Oktober 1988 ein „White Paper" mit Bezug auf internationale Verrechnungspreise zwischen multinationalen Gesellschaften. Dieser Artikel beschreibt im kurzen eine Anzahl von wichtigen internationalen Steuerbestimmungen des TAMRA und einige Begriffe, die im Verrechnungspreisbericht besprochen wurden.

Léonard W. Rothschild, Jr. et Patti L. Rae:

Etats-Unis: Points importants de la Section 482 du "White Paper" (Rapport officiel du Gouvernement) 177
La loi sur la réforme fiscale de 1986 a introduit un nouveau concept se rapportant aux paiements liés au transfert de biens incorporels, à savoir: l'attention était transférée du concept de prix incontrôlé et comparable à celui de proportionné au revenu. L'Administration Fiscale et le Ministère des Finances ont conjointement publié le 18 octobre 1988 le "White Paper" en réponse aux modifications quant aux prix de transfert. M. Rothschild et Mme Rae mettent en lumière les points les plus importants de ce "White Paper", introduisant les méthodes utilisées pour évaluer les biens incorporels (comparaison exacte ou par assimilation, base du taux de remboursement suivant le principe d'assimilation à une entreprise indépendante: "Basic Arm's Length Rate of Return = BALRM" et BALRM avec partage du bénéfice), la documentation et les dispositions portant sur l'application par les contribuables des leurs obligations, les autorités compétentes, la double imposition ainsi que le manque de dispositions prévoyant des facilités fiscales.

Leonard W. Rothschild Jr. und Patti L. Rae:

U.S.A.: Kurzer Überblick des Berichts (White Paper) hinsichtlich des Paragraphen 482 des amerikanischen Steuergesetzes 177
Das Steuerreformgesetz 1986 führte einen neuen Begriff ein in Bezug auf Zahlungen im Zusammenhang mit immateriellen Wirtschaftsgütern, d.h. der Schwerpunkt wurde vom Begriff des „comparable uncontrolled price" zum Begriff des „commensurate with income" verlagert. Die amerikanische Steuerverwaltung (Internal Revenue Service) und das Finanzministerium (Treasury Department) veröffentlichten am 18. Oktober 1988 einen gemeinsamen Bericht (White Paper) hinsichtlich der Änderungen, die vom Steuerreformgesetz 1986 mit Bezug auf Verrechnungspreise multinationaler Gesellschaften eingeführt wurden. Herr Rothschild und Frau Rae beschreiben im kurzen die wichtigsten Merkmale des Berichts, einschliesslich der Bewertungsmethoden für immaterielle Wirtschaftsgüter („exact comparable", „inexact comparable", „basic arm's length rate of return (BALRM)" und „BALRM with profit split"), Dokumentierungs- und Durchführungsbestimmungen, zuständige Behörden, Doppelbesteuerung und die Abwesenheit von Bestimmungen, welche den Steuerpflichtigen Sicherheit bieten (safe harbour provisions).

Luis Guillermo Morales:

Colombie: Nouvelles dispositions fiscales 181
Une série de nouvelles dispositions fiscales ont été dernièrement adoptées par le Congrès et le Gouvernement National de Colombie; ces dispositions affectent entre autres: l'impôt sur la fortune, le revenu présumé, les demandes de renseignements auprès des banques, les dépenses non-déductibles, les amortissements, les mauvaises dettes et le leasing. Cet article résume un certain nombre de ces nouvelles dispositions.

Luis Guillermo Morales:

Kolumbien: Neue Steuermassnahmen 181
Eine Anzahl von neuen Steuermassnahmen wurde kürzlich von der nationalen Regierung und vom Parlament Kolumbiens verabschiedet. Diese Massnahmen betreffen u.a. die Vermögensteuer, die Einkommenpauschalbesteuerung, die Verpflichtung, welche Banken auferlegt wurde, um Auskunft zu erteilen, sowie nicht-abzugsfähige Ausgaben, Abschreibung, zweifelhafte Debitoren und Leasinggeschäfte. Dieser Artikel bietet einen kurzen Überblick über diese neuen Massnahmen.

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Luiz Fernando Teixeira Pinto:

Brésil: Le système fiscal brésilien en conformité avec la nouvelle constitution fédérale de 1988 ..... *183*
La nouvelle constitution brésilienne, promulguée le 5 octobre 1988, introduit des modifications importantes aussi bien en matière politique qu'économique. La première partie de la constitution est consacrée à la fiscalité. Cet article met en lumière les modifications les plus importantes apportées au système fiscal brésilien.

Arthur Young International:

Impôt sur le revenu des personnes physiques en France *187*
Le quatrième article de notre série consacrée à l'imposition des expatriés analyse la situation en France.

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Luiz Fernando Pinto:

Brasilien: Das brasilianische Steuersystem nach der Einführung der neuen föderalen Verfassung von 1988 ..... *183*
Die neue brasilianische Verfassung, die am 5. Oktober 1988 erlassen wurde, stellt wesentliche politische und wirtschaftliche Änderungen vor. Der erste Teil dieser Verfassung befasst sich ausschliesslich mit Steuerangelegentheiten. Dieser Artikel bietet eine Kurzdarstellung der wichtigsten Änderungen, die im brasilianischen Steuersystem eingeführt wurden.

Arthur Young International:

Die Einkommensteuer in Frankreich *187*
Der vierte in unserer Reihe von Artikeln über die Besteuerung von ausländischen Arbeitnehmern befasst sich mit der Situation in Frankreich.

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The Sixth Annual Summer Program in United States Law and Legal Institutions

17 July 1989 – 18 August 1989

The Sixth Annual Summer Program in United States Law and Legal Institutions is intended to give lawyers and advanced law students from other countries intensive exposure to the basic structure of the United States legal system and to significant areas of U.S. law. The Program should give participants both a basic understanding of the United States legal system and the U.S. legal profession and an in-depth exposure to specific areas of U.S. law that affect a broad range of commercial, investment, and personal activities. It is designed to serve as a low-cost alternative to a full-year's program in U.S. law or as a preface to advanced formal training in the United States.

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For more detailed information regarding the program, write to:

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University of Wisconsin
Law School
Room 208
Madison, Wisconsin 53706
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Anti-Avoidance and Tax Treaty Policies and Practice in the Asian-Pacific Region

on

9 - 12 June 1989

at

the Plaza International Hotel
Wellington, New Zealand

The Conference, *Anti-Avoidance and Tax Policies and Practice in the Asian-Pacific Region,* has been jointly organised by the Asian-Pacific Tax and Investment Research Centre and the Institute of Policy Studies, with the assistance of the Australian Tax Research Foundation. It will be held over 3½ days to examine specific anti-avoidance taxation policies of 10 countries in Asia and the Pacific, including Canada and the USA.

A systematic rather than national approach has been adopted for the Conference. Discussion at technical sessions (see below) will be conducted on a panel rather than a lecture basis. Each session will be introduced with two individual presentations, the remainder of the session will be coordinated by the panel chairperson. The technical programme covers domestic responses to specific tax avoidance issues and developments in bi-lateral tax treaty measures and policy in respect of anti-avoidance issues.

Dates and Accommodation

The Conference will commence at 9.30 am on Friday, 9 June and will finish on Monday, 12 June 1989.

Accommodation can be reserved at the Plaza International Hotel, Wellington. The daily room rate is NZ$ 170 + GST.

Conference fee is NZ$ 1,650 and covers conference facilities, documentation, lunch and refreshments each day.

A cheque payable to the Institute of Policy Studies should be mailed together with the registration details to:

Conference Manager
Anti-Avoidance Tax Policies in Asia and the Pacific
Institute of Policy Studies
Victoria University of Wellington
P.O. Box 600
Wellington
NEW ZEALAND

TECHNICAL PROGRAMME

1. Legislative and judicial anti-avoidance rules
2. Tax treaties and residence rules for individuals and companies
3. Taxation of financial transactions
4. Controlled foreign company legislation
5. Transfer pricing legislation and enforcement
6. Exchange of information and dispute resolution
7. Model tax treaty for the region

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Please register the following delegates for Anti-Avoidance and Tax Treaty Policies and Practice in the Asian-Pacific Region.

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NEW ZEALAND:

An Analysis of the New Residence Requirements

D.J. Hasseldine

Mr. Hasseldine is a full-time lecturer in Accountancy at the University of Canterbury and is the author of numerous articles.

I. INTRODUCTION

Taxation law in New Zealand has in the last year or so been subject to a number of very major reforms which have been wide in their scope. Consequently, it is appropriate to examine the rules affecting residence in New Zealand, especially as these too have just been subjected to a major amendment.

The new imputation and international tax regimes now operating acted as a catalyst to these residence changes. For example, the Branch Equivalent regime applies to residents in respect of interests in foreign companies that are controlled by New Zealand residents. Other parts of the international tax regime also have residence definitions as a key element in their operation. Similarly, only resident companies and individuals can respectively allocate and utilize imputation credits. The Consultative Committee considering these reforms isolated the deficiencies in the previous rules and recommended strengthening them to facilitate New Zealand residence and to make non-residence status much more difficult to achieve. The New Zealand Government has acted on these recommendations.[1]

Residence is also an important topic in that it often determines tax liability either through the domestic legislation or through the operation of a bilateral double taxation agreement. Sec. 242 of the New Zealand Income Tax Act 1976[2] states that all (i.e. world-wide) income derived by a New Zealand resident shall be assessable for income tax and secondly, all income derived from New Zealand (via the source rules in Sec. 243) is also assessable. As may be expected, there is a mechanism which allows a credit in respect of foreign tax paid by residents in respect of income derived out of New Zealand.

This article is structured in 2 major sections respectively dealing with individual and company residence. To appropriate the transition, the new requirements are examined in the context of the previous rules, case law and the practice of the New Zealand Inland Revenue Department.

II. INDIVIDUAL RESIDENCE

A. Position prior to amendment

The rules for individual residence were amended with 2 separate commencement dates. Individuals resident in New Zealand under the old rules on 6 December 1988 became subject to the new rules on 7 December 1988. In all other cases, the new law applies from the start of the 1990 income year – typically 1 April 1989.

Under the old rules the primary basis of determining residence was a personal presence test with a secondary permanent place of abode test that applied in certain instances.

Personal presence test

An individual was deemed to be resident in New Zealand if personally present in New Zealand for a *continuous period* of at least 365 days, with the proviso that where a taxpayer requested the Commissioner to determine that his permanent place of abode was outside New Zealand he would be classed as non-resident.

The opposite also held true if personally absent from New Zealand for a continuous period of at least 365 days: non-residence status could be obtained, although again, it was possible to request the Commissioner to determine whether the taxpayer had a permanent place of abode in New Zealand. If the Commissioner judged this to be the case, the taxpayer would be regarded as resident in New Zealand.

The definition of "continuous period" altered the meaning of the above rules which at first glance appear straightforward. A continuous period was an unbroken period of days which was deemed unbroken if any one break was no greater than 28 days and the total number of break days no greater than 56 days. This

1. The amending legislation was the Income Tax Amendment Act (No. 5) 1988, which received Royal Assent on 16 December 1988.
2. All section references in this article are to the Income Tax Act 1976.

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allowed for some flexibility in travel movements during the year without causing a change of residence. The operation of these rules is shown below:
Assume a New Zealander:
- departed from New Zealand 1 November 1987
- arrived in New Zealand 10 December 1987
- departed from New Zealand 31 December 1987
- returns to New Zealand 1 November 1988

As the intervening number of days in December was less than 28 days, the full 12 months constitute a "continuous period" for the 365-day test.

Permanent place of abode

Under the old rules, ambiguity could arise – e.g. an individual might be neither personally present nor absent for a full 365-day period. For example, a continuous absence of 29 days would have been sufficient to break the personal presence test yet insufficient to qualify for non-resident status.

In this case the *permanent place of abode* test (contained in Sec. 241(1A)) operated. The actual phrase was not, however, defined in the Act. Due to a dearth of New Zealand cases on this topic, Alston[3] looked to an Australian case for help.[4] In this case, the taxpayer was posted to the New Hebrides, but was forced to return to Australia early due to ill health. It was held that an intention to return to Australia would not be sufficient of itself to give the taxpayer a permanent place of abode in Australia. Alston took the view that this interpretation would have been valid in a New Zealand context.

The Commissioner of Inland Revenue takes into account the following factors in determining a permanent place of abode:
- time in New Zealand – fixed period or contract;
- accommodation – renting in New Zealand, overseas home sold?;
- employment history – length of residence in country of claimed permanent place of abode;
- financial ties overseas – bank accounts, investments, etc.;
- family – location of immediate relatives;
- sporting, professional and trade associations;
- receipt of social welfare benefits;
- annual leave – does taxpayer return to "home" country?

Since Alston's 1982 article, there have been 2 New Zealand cases dealing with the interpretation of "permanent place of abode". In Taxation Review Authority (TRA) Case No. 83/125[5], a New Zealand university lecturer went on study leave, leasing his own home out and renting a home in Cambridge, England. As he was not out of the country for 365 days, he could not rely on the personal absence test, so he claimed that he had no permanent place of abode in New Zealand even though his university salary continued to be paid to him. The taxpayer suggested that the intention of the legislation was that absences close to 365 days should be a relevant factor in determining the permanent place of abode.

The Judge hearing the case distinguished *Applegate,* stating that the question in issue was similar but the facts were different. He stated:

> In the context of this part of the Act the "place of abode" I think means a place where one usually lives. A permanent place of abode means the lasting or enduring, as opposed to the temporary, place where one usually lives. In determining that issue the taxing year in question is a relevant period to consider; however, under the New Zealand legislation the relevant time to determine whether the income is derived from New Zealand, or a person is a resident of New Zealand, is when the income is actually derived.

Taking all of the facts into account (along the lines that the Commissioner of Inland Revenue considers), it was held that the lecturer's permanent place of abode was in fact New Zealand.

A second case concerned a marine engineer who left New Zealand to work on a ship and between voyages he stayed in England.[6] In order to obtain a refund of U.K. tax he tendered a form to the New Zealand revenue who completed a section certifying New Zealand residence and then despatched it to England. The taxpayer, having returned to New Zealand, then claimed, as he was absent for over 365 days, no New Zealand tax was payable. The Judge stated:

> I find that in requesting the respondent to certify, on the form supplied by the Inspector of Taxes, Cardiff, that the objector was resident in New Zealand at material times, the objector was also requesting the respondent to determine that he had a permanent place of abode in New Zealand at all times during his period of absence in terms of the proviso to section 241(1C) (the 365 day test for absence).

It follows from these 2 cases that obtaining the determination of a permanent place of abode overseas is not easily achieved, with the possibility of being resident for tax purposes in no country at all, even more remote.

Special provision was made for public servants overseas on Government service (e.g. diplomats who continued to be treated as residents).

B. Position after amending legislation

The test has been altered so that residence is obtained if:

(1) A person has a permanent place of abode in New Zealand whether or not he also has a permanent place of abode in another country (Sec. 241(1));
or
(2) A person is personally present in New Zealand for more than 183 days over any 12-month period. Resi-

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3. See Alston, A., "The Concept of Residence", *New Zealand Current Taxation,* Vol. 27, No. 2 (December 1982).
4. *Federal Commissioner of Taxation vs. Applegate,* (1979) 27 *Australian Law Reports* 114.
5. Reported as Case F138 (1984) 6 *New Zealand Tax Cases* ("N.Z.T.C.") at 60,237.
6. Case J41 (1987) 9 N.Z.T.C. at 1,243.

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dence commences from the first day of personal presence (Sec. 241(2)).

Non-residence is obtained where:
A person is personally absent from New Zealand for more than 325 days in aggregate over any 12-month period. Non-residence commences on the first day of personal absence (Sec. 241(3)).

From the above it is clear that in order to be non-resident not only must one be absent for the required period, but also there must be no permanent place of abode in New Zealand.

Individuals present in New Zealand for part of a day are deemed to be personally present for the whole of that day.

The special provision for public servants has been retained with individuals absent on Government service continuing to be deemed New Zealand resident.

III. CORPORATE RESIDENCE

A. Position prior to amendment

Previously a company was deemed resident if:
(a) it was incorporated in New Zealand; or
(b) its centre of administrative management was in New Zealand.

There are no New Zealand cases on company residence so reference is normally made to a leading case such as the *De Beers*[7] case where residence was held to be where the directors' meetings were held and the real business of the company was carried on.

As Dodds noted, the Commissioner has typically interpreted the *centre of administrative management* as being practical day to day management (although it may be amended by a double taxation agreement). This has meant that even where shareholders and directors had overriding control from New Zealand, it was very easy for non-residence to be obtained if the company was incorporated overseas with at least some local management. This is illustrated by the following extract from the Commissioner's own Technical Rulings:[8]

> We should not strive too hard to apply section 241 in the case of an overseas subsidiary of a New Zealand company if:
> - The income of the subsidiary is self-generated in the overseas country and does not arise in that country from goods or other transactions sold or made by the parent company.
> - There is a fair degree of management in the overseas country, particularly if New Zealand directors tend to go there to hold board meetings rather than hold them in New Zealand.

This dichotomy in interpretation between Inland Revenue practice and the interpretation suggested by case law (i.e. the place where the highest level of decision-making takes place (*De Beers)),* was a strong factor leading to the change of the corporate residence test.

B. Position after amending legislation

The residence test of companies has been altered with effect from the commencement of the 1989/1990 income year so that a company is resident if it:
– is incorporated in New Zealand;
or
– has its head office in New Zealand;
or
– has its centre of management in New Zealand;
or
– the directors, acting in their capacity as directors, exercise control of the company in New Zealand (whether or not decision-making by directors is confined to New Zealand).

The effect of this amendment is to retain the place of incorporation test and a strengthened place of management test, with the addition of a control test as well. Management and control tests have much more economic substance than place of incorporation tests and the change will bring New Zealand corporate residence rules more in line with overseas practice.

It should be noted that in cases where dual residence applies it is necessary to refer to the tie-breaking provisions of any double taxation agreement in force. In the case of New Zealand, the tie-breaking rules are largely the place of effective management and the centre of administrative or practical management. The specific terms for each of New Zealand's double taxation agreements are set out in the Appendix, with many agreements also stating that regard should be had to the place of incorporation and that the issue should, if possible, be settled by mutual agreement between the competent authorities. The actual interpretation of these terms will of course depend on Revenue practices and legal precedents in the country concerned.

Companies affected by the foreign investment fund provisions

It is important to note that a different commencement date applies to those companies affected by the foreign investment fund provisions (Sec. 245Q). In those cases, the commencement date of the new residence rules is the income year commencing 1 April 1988 or for non 31 March balance dates, the first day of the 1988/1989 income year.

Grouping provisions

Sec. 191 of the New Zealand Income Tax Act is the relevant section dealing with groups of companies and the offsetting of losses, and where the shareholding is not 100% common, the treatment of subvention payments. It should be noted that dual resident companies cannot be part of a New Zealand group for tax purposes, i.e. under Sec. 191(7E) there are no provisions

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7. *De Beers Consolidated Mines vs. Howe*, (1906) *Appeal Cases* 455. See also *Malayan Shipping Co. vs. Federal Collector of Taxes*, (1946) 8 *Australian Tax Decisions* 75.
8. Chapter 10, Part 1 at 16.

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available for the intragroup offset of losses against profits when dual residence applies. Similarly, as a consequence of the new subsec. 191(7F), which applies retrospectively from the income year 1 April 1988, no grouping provisions are now available to companies which are incorporated outside New Zealand but not dual resident. This latter case does not apply to companies engaged in business in New Zealand through a fixed establishment if any profits which would have otherwise arisen through the transaction would have been taxable.

IV. CONCLUSIONS

It is clear that the recent legislative changes represent a major strengthening of New Zealand's residence rules. Temporary changes of residence by companies controlled by residents did not pose an enormous problem to the Revenue authorities as amendments have been made to the grouping provisions in recent times and they would now fall under the new international tax regime in any case.

The changes to individual residence are, however, significant in effect. First, the previous "continuous period" concept, which had little impact has been removed. The new rules make it much more difficult to achieve non-resident status by requiring both personal absence for 325 days and no permanent place of abode in New Zealand.

This will have a significant effect on the tax planning undertaken by those individuals arriving and departing New Zealand and to companies employing New Zealanders overseas. There will be an increased focus on structuring taxation affairs around the "permanent place of abode" concept, with close attention being paid to the specific factors considered significant by the Inland Revenue Department as outlined in Part II.

The strengthened residence rules are intended to widen the scope of New Zealand residence. It will inevitably result in more companies being resident in more than one tax jurisdiction. The consequence is likely to be an increasing number of tie-breaking cases under the various double taxation agreements which will need to be settled by mutual cooperation and agreement between the Revenue authorities concerned. Companies exposed to these changes in New Zealand should by now be studying the likely impact of the new legislation.

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Report of the Consultative Committee on International Tax Reform, Part 2, July 1988, Government Printer, Wellington.

APPENDIX

Tie-breaking Rules for Corporate Residence under New Zealand's Double Taxation Agreements

Australia – centre of administrative or practical management
Belgium – place of effective management
Canada – place of effective management
China – where "head office" is situated
Denmark – place of effective management
Fiji – centre of effective management
Finland – place of effective management
France – place of effective management
Germany (Federal Republic) – place of effective management
India – place of effective management
Italy – place of effective management
Japan – managed and controlled head or main office
Malaysia – centre of administrative or practical management
Netherlands – place of effective management
Norway – place of effective management
Philippines – day to day management
Republic of Korea – place of effective management
Singapore – centre of administrative or practical management
Sweden – centre of administrative or practical management
Switzerland – place of effective management
United Kingdom – place of effective management
United States of America – by mutual agreement

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AUSTRALIA:

TAXATION RULING IT 2507: FOREIGN TAX CREDIT SYSTEM: FOREIGN TAXES ELIGIBLE FOR CREDIT AGAINST AUSTRALIAN INCOME TAX

Income Tax Assessment Act 1936 ss 6AB(2), 6AB(6), 160AF

Date of issue: 10 November 1988
Date of effect: Immediate

Note:
- Income Tax Rulings do not have the force of law
- Each decision made by the Australian Taxation Office is made on the merits of each individual case, having regard to any relevant ruling.

PREAMBLE

1. Taxation Ruling IT 2437 sets out the relevant legislative provisions and general criteria which apply in determining whether a foreign tax is a creditable tax under the general foreign tax credit system (FTCS).

2. That Ruling contains a non-exhaustive list of foreign taxes which are recognised as creditable taxes. Paragraph 7 of the Ruling foreshadows periodical updates of that list – in the form of future Rulings incorporating an updated consolidated list of creditable taxes – as a consequence of changes in other countries' taxes and as other foreign taxes are admitted as creditable taxes. This Ruling represents the first of such updates.

3. While the issue of this Ruling in that form will obviate the need for reference back to the list of creditable taxes contained in IT 2437, the comments in the Preamble to that Ruling concerning the relevant statutory provisions and guidelines for creditable tax determinations remain pertinent [see box at the following page]. In particular, it is emphasised that taxpayers who seek credit for foreign taxes not identified in this Ruling (or in the subsequent Rulings) should supply the following details of those taxes in the relevant income tax returns:
- the precise title of the tax;
- the title of the law under which the tax is imposed;
- whether the tax is levied by a national, state or local authority and the name of that authority; and
- a description of the nature of the tax and the basis for its implementation.

4. Decisions as to whether particular foreign taxes not included in this Ruling (or in subsequent Rulings) are creditable taxes under the FTCS will continue to be taken in National Office. Branch Offices should therefore refer enquiries received, or claims in returns, in relation to such taxes to National Office for consideration and advice. It would also continue to assist with the processing of returns if taxpayers were to supply relevant details to National Office as soon as a liability to pay such a foreign tax becomes apparent.

RULING

5. Subject to the provisions of Division 18 of Part III of the Income Tax Assessment Act 1936, a taxpayer will be entitled to a credit against Australian tax payable on foreign income for any of the foreign taxes listed below paid in respect of that income (changes and additions to the taxes listed in IT 2437 are marked with an asterisk):

ARGENTINA
Income tax (Impuesto a las ganancias)
Tax on casual gains (Impuesto sobre los beneficios eventuales)

AUSTRIA
Income tax (Einkommensteuer)
Corporation tax (Körperschaftsteuer)
Tax on interest yields (Zinsertragsteuer)
Directors' tax (Aufsichtsratsabgabe)
Tax on commercial and industrial enterprises (Gewerbesteuer), only where levied on a basis other than capital or the sum of wages.

BANGLADESH
Income tax

BELGIUM
Individual income tax (impôt des personnes physiques/personen belasting)
Corporate income tax (impôt des sociétés/ vennootschapsbelasting
Income tax on legal entities (impôt des personnes morales/rechtspersonenbelasting)
Income tax on non-residents (impôt des non- résidents/belasting der nietverblijfhouders) including the prepayments, the surcharge on these taxes and prepayments, and the communal supplement to the individual income tax.

BRAZIL
Income tax (Imposto de renda)
Withholding tax on pure income, e.g. interest or dividends
Supplementary tax (Imposto suplementar), where charged on dividends or branch profits arising in Brazil)
Payments to the development funds PIN and PIS (Programa de intergracao nacional/social) and MOBRAL (Fundacao moviments brasileiro de alfabetizacao)

BRUNEI
Income tax
Petroleum income tax

BURMA
Income tax

CANADA
Federal: Income taxes imposed by the Government of Canada
Provincial:
ALBERTA
Provincial income tax
BRITISH COLUMBIA
Provincial income tax
Mining tax
Mineral resource tax
Logging tax
MANITOBA
Provincial income tax
NEW BRUNSWICK
Provincial income tax
Mining tax
NEWFOUNDLAND
Provincial income tax
Mining tax
NOVA SCOTIA
Provincial income tax
Mining tax
ONTARIO
Provincial corporation tax on company profits
Provincial income tax on individuals
Mining tax
PRINCE EDWARD ISLAND
Provincial tax
QUEBEC
Provincial corporation tax on company profits
Provincial income tax on individuals
Mining tax
Logging tax
SASKATCHEWAN
Provincial income tax
Mining royalty tax

CHILE
Income tax (Impuesto a la renta)
Additional tax (Impuesto adicional)
Additional tax (Tasa adicional)

CHINA
Individual income tax
Income tax concerning joint ventures with Chinese and foreign investment
Income tax concerning foreign enterprises
Local income tax

COOK ISLANDS
*Income tax (including withholding tax)

CYPRUS
Income tax
Special contributions under Law 55 of 1974 and subsequent annual extensions

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The relevant parts of IT 2437 are as follows:

1. New Division 18 of the Income Tax Assessment Act (inserted by the Taxation Laws Amendment (Foreign Tax Credits) Act 1986 and first applicable to assessments for the year of income commencing 1 July 1987) provides for the granting of credits in respect of foreign tax. Section 160AF(1) provides that a resident taxpayer, whose assessable income includes foreign income on which the taxpayer has paid foreign tax, is entitled to a credit against the Australian tax payable of the amount of that foreign tax, up to the amount of Australian tax payable on the foreign income.

2. Section 6AB(2) specifies in general terms the nature of the foreign taxes for which credit is allowable. First, the tax must be imposed by the law of a foreign country, whether it be at national, state, local or other government level (s 6AB(6)). Secondly, it must be either:
- a tax imposed upon income or upon profits or gains, whether of an income or capital nature;
- a tax deemed, under s 160AFC, to have been paid in respect of a dividend (i.e., underlying foreign company tax on profits out of which a dividend is paid by a related foreign company to an Australian resident company); or
- a tax subject to a comprehensive taxation agreement to which Australia is a party and having the force of law under the Income Tax (International Agreements) Act 1953.

3. However, the subsection specifically excludes from its ambit a foreign tax that is a unitary tax, as defined in s 6AB(6). (A further Ruling concerning unitary taxes is proposed.)

4. The law does not identify specific taxes of particular countries as being either creditable or not creditable; that has been left to be determined by the application of the above criteria on a case-by-case basis.

5. Essentially, foreign tax must be imposed on a basis substantially equivalent to that on which the Income Tax Assessment Act operates. That is, it must be imposed on the basis of a taxpayer's net income or gains, whether of an income or capital nature, or be a withholding tax on outgoing payments (imposed as a final tax and not be later creditable against the ultimate foreign tax liability of the taxpayer) similar to the Australian withholding tax on the gross amount of outgoing dividends and interest payments. This has been the basis which has been used in the past to measure whether a foreign tax qualifies as a tax that would render an Australian resident recipient of the income upon which it is imposed eligible for the exemption from Australian tax provided by s 23(q) of the Assessment Act.

CZECHOSLOVAKIA
Tax on profits (Dan ze zisku)
Artists' tax (Dan z prijmu literarni a umelecke cinnosti)

DENMARK
Income taxes to the State and to the municipalities (indkomstskatterne til staten og til kommunerne)

FINLAND
State income tax
Communal tax
Church tax
Tax withheld at source from non-residents' income

FRANCE
Income tax and corporation tax including any withholding tax, prepayment (précompte) or advance payment with respect to the aforesaid taxes

FRENCH POLYNESIA (TAHITI)
Corporation tax (Impôt sur les bénéfices des sociétés)
Territorial solidarity tax (Prélèvement territorial de solidarité)
Extraordinary solidarity tax (Prélèvement exceptionnel de solidarité)

FIJI
Income tax (including basic tax and normal tax)
Non-resident dividend withholding tax
Interest withholding tax
Royalty withholding tax
Dividend tax
Land sales tax

GERMAN DEMOCRATIC REPUBLIC
Corporation tax (Körperschaftsteuer)
Trade tax (Gewerbesteuer) to the extent that it is computed by reference to trading profits
Wages tax (Lohnsteuer)

GERMANY (FEDERAL REPUBLIC)
Income tax (Einkommensteuer) including the surcharge (Ergänzungsabgabe) thereon
Corporation tax (Köperschaftsteuer) including the surcharge (Ergänzungsabgabe) thereon

GHANA
*Income tax

GREECE
Income tax, including schedular or analytical tax

HONG KONG
Tax on earnings, profits and interest, comprising:
- salaries tax
- profits tax
- interest tax

HUNGARY
Income taxes (a jovedelemadok)
Profit taxes (a nyeresegadok)
Enterprises special tax (a vallalati kulonado)
Contribution to communal development (a kozsegfejlesztesi hozzajarulas)
Levy on dividends and profit distributions of commercial companies (a kereskedelmi tarsasagok osztalek es nyereseg kifizetesei utani illetek)

INDIA
Income tax, including any surcharge thereon
Income tax and super tax levied by states on agricultural income
Surtax imposed on chargeable profits of companies

INDONESIA
Income tax (pajak pendapatan)
Company tax (pajak perseroan)
Withholding tax on interest, dividends and royalties (pajak atas bunga, dividen dan royalty)

IRELAND
Income tax
Corporation tax
Capital gains tax

ISRAEL
Income tax (including capital gains tax)
Company tax
Tax on gains from the sale of land under the Land Appreciation Tax Law

ITALY
Individual income tax (Imposta sul reddito delle persone fisiche)
Corporate income tax (Imposta sul reddito delle persone giuridiche) even if they are collected by withholding taxes at source
Local tax on income (Imposta locale sui redditi)
Communal tax on capital appreciation of real property (Imposta comunale sull incremento di valore degli imm (INVIM)), where charged on a capital gain also chargeable in Australia

JAPAN
Income tax
Corporation tax
Enterprise tax, so far as payable on profits or income
Local (prefectural or municipal) inhabitant taxes, so far as payable on profits, income or chargeable gains from sources in Japan

JERSEY
*Income tax

KENYA
Income tax

REPUBLIC OF KIRIBATI
*Income tax

REPUBLIC OF KOREA
Income tax
Corporation tax
Inhabitant tax
Defence tax, where charged by reference to income tax or corporation tax

LIBERIA
*Income tax

LUXEMBOURG
Income tax on individuals (Impôt sur le revenu des personnes physiques)
Tax on fees of directors of companies (Impôt sur les tantièmes)
Corporation tax (Impôt sur le revenu des collectivités)
Tax on the total amount of wages and salaries (Impôt commercial communal y compris l'impôt sur le total des salaires), except in so far as it is computed on a basis other than profits

MACAU
Complementary tax on income (imposto complementar de rendimentos)

MALAYSIA
Income tax and excess profit tax
Supplementary income taxes (i.e. tin profits tax, development tax and timber profits tax)
Petroleum income tax
Real property gains tax

MALTA
Income tax, including prepayments of tax,

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whether made by deduction at source or otherwise

MEXICO
Income tax
Federal District tax on income from capital (Impuesto sobre productos de capitales)
Federal District surcharge, in so far as charged on the tax above

MONACO
Tax on profits (Impôt sur les benefices)

NETHERLANDS
Income tax (Inkomstenbelasting)
Wages tax (Loonbelasting)
Corporation tax (Vennootschapsbelasting)
Dividend tax (Dividend belasting)

NEW ZEALAND
Income tax
Excess retention tax
*Non-resident withholding tax

NIGERIA
*Personal income tax

NIUE
*Income tax

NORWAY
National tax on income (Inntektsskatt til staten)
County municipal tax on income (Inntektsskatt til fylkeskommunen)
Municipal tax on income (Inntektsskatt til kommunen)
National contributions to the Tax Equalization Fund (Fellesskatt til Skattefordelingsfondet)
National tax relating to income from the exploration for and the exploitation of submarine petroleum resources and activities and work relating thereto, including pipeline transport of petroleum produced (Skatt til staten vedrorende inntekt og formue i forbindelse med undersokelse etter og utnyttelse av undersjoiske petroleumsofrekomster og dertil knyttet virksomhet og arbeid, herunder rorledningstransport av utvunnet petroleum)
National dues on remuneration to non-resident artistes (avgift til staten av honorarer som tilfaller kunstnere bosatt i utlandet)
Seamen's tax (Sjomannsskatt)

PAKISTAN
Income tax
Super tax

PAPUA NEW GUINEA
The income tax imposed under the law of Papua New Guinea, including:
- salary or wages tax;
- additional profits tax upon taxable additional profits from mining operations;
- additional profits tax upon taxable additional profits from petroleum operations;
- specific gains tax upon taxable specific gains; and
- dividend withholding tax upon taxable dividend income

PHILIPPINES
Income tax imposed by the Government of the Republic of the Philippines

POLAND
Income tax (podatek dochodowy)
Tax on wages and salaries (podatek ad wynagrodzen)
Surcharge on the income tax or on the tax on wages or salaries (podatek wyrownawczy)

PORTUGAL
Agricultural tax (Imposto sobre a industria agricola)
Industrial tax (Contribuição industrial)
Tax on income from capital (Imposto de capitais)
Professional tax (Imposto profissional)
Complementary tax (Imposto complementar)
Tax on capital gains (Imposto de mais-valias)
Any surcharges on the preceding taxes

ROMANIA
Tax on incomes derived by individuals and corporate bodies (Impozitul pe veniturile realizate de persoane fizice si juridice)
Tax on the profits of joint companies constituted with the participation of some Romanian economic organizations and some foreign partners (Impozitul pe beneficiile societatilor mixte, constituite cu participare romana si straina)
Tax on income realised from agricultural activities (Impozitul pe veniturile realizate din activitati agricole)

SINGAPORE
Income tax

SOLOMON ISLANDS
Income tax

SOUTH AFRICA
Normal tax (the general income tax)
Non-resident shareholders' tax
Undistributed profits tax
Non-residents' tax on interest
*Non-residents' tax on royalties

SPAIN
Individual income tax (Impuesto sobre la renta de las personas fisicas)
Company tax (Impuesto sobre sociedades)
Local taxes on income
*Chamber of Commerce surcharge based on admissible taxes

SRI LANKA
Income tax

SWEDEN
State income tax including sailors tax and coupon tax
Tax on undistributed profits of companies and the tax on distribution in connection with reduction of share capital or the winding-up of a company
Tax on public entertainers
Communal income tax

SWITZERLAND
The Federal, cantonal and communal taxes on income (total income, earned income, income from capital, industrial and commercial profits and other items of income)

TAIWAN
Business income tax
Personal income tax
Withholding tax on interest
Withholding tax on dividends

THAILAND
Income tax
Petroleum income tax

TURKEY
Income tax, including withholding or "stoppage" tax where charged on net profits
Corporation tax, where charged on net profits

TUVALU
Income tax

UNITED KINGDOM
Income tax (including surtax)
Corporation tax
Capital gains tax

UNITED STATES OF AMERICA
Federal: Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax and the personal holding company tax
*Contributions under the Federal Insurance Contributions Act (FICA)
State or other: As detailed below, but note that any state or other tax which may be construed as a unitary tax (as defined by s 6AB(6) of the Australian Income Tax Assessment Act) is not creditable
ALABAMA
Income tax on individuals
General income tax
ALASKA
General income tax
ARIZONA
General income tax
ARKANSAS
Income tax
CALIFORNIA
Bank and corporation income tax
*Bank and corporation franchise tax
Excise (income) tax, except where it represents a minimum levy
Personal income tax
Insurance companies tax on marine insurance companies
COLORADO
General income tax
Excise (income) tax
CONNECTICUT
Corporation business tax where it is charged on income
DELAWARE
Corporation income tax
Personal income tax
DISTRICT OF COLUMBIA
Individual and corporate income tax
FLORIDA
Corporation income tax
GEORGIA
General income tax
HAWAII
General income tax
IDAHO
General income tax
ILLINOIS
Income tax
Corporate replacement income tax (personal property replacement tax)
IOWA
General income tax
KANSAS
Income tax
KENTUCKY
General income tax
LOUISIANA
General income tax

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MAINE
Corporate income tax
Personal income tax
MARYLAND
Income tax
MASSACHUSETTS
Corporate excise (income) tax, where charged on net income
Personal income tax
MICHIGAN
Income tax
Single business tax
MINNESOTA
Income tax
MISSOURI
Income tax
MONTANA
Corporate income tax (licence)
Personal income tax
NEBRASKA
Personal income tax
NEW HAMPSHIRE
Business profits tax
NEW JERSEY
Corporation franchise tax except where it represents a minimum levy or is charged on amounts other than net income
Insurance companies tax on marine insurance companies
Personal income tax
NEW MEXICO
Income tax
NEW YORK CITY
Earnings tax on non-residents where it is charged on salaries
Financial corporation tax where it is charged on income
General corporate (income) tax, where charged on net income
Personal income tax on residents where it is charged on salaries
NEW YORK STATE
Personal income tax
Unincorporated business tax
*Corporate franchise tax where it is charged on the basis of net income. Where charged on a basis other than net income, credit is allowable up to the amount of tax that equates with the amount of tax that would have been payable if the net income basis had applied.
NORTH CAROLINA
General income tax
Financial institutions excise tax, except where it represents a minimum levy
NORTH DAKOTA
General income tax
OHIO
Corporation franchise tax when charged on net income
Income tax (Canton, Cincinnati, Cleveland, Columbus and Toledo)
Net profits tax (Cleveland)
OKLAHOMA
General income tax
OREGON
Corporate (excise) income tax
Personal income tax
PENNSYLVANIA
Corporate net income tax except where it is charged on amounts other than net income
Personal income tax
Philadelphia net profits and wages tax
Philadelphia city tax
RHODE ISLAND
Business corporate tax where charged on net income
SOUTH CAROLINA
Income tax
TENNESSEE
Corporate excise (income) tax
UTAH
Corporation franchise tax when charged on net income
VERMONT
Corporate income tax
Personal income tax
VIRGINIA
Direct corporate income tax
Personal income tax
WISCONSIN
Corporate franchise tax
Income tax

U.S.S.R.
Income tax on foreign legal persons
Income tax on the population

WESTERN SAMOA
Income tax

YUGOSLAVIA
Tax on income of a basic organization of associated labour
Tax on a worker's personal income
Tax on personal income derived from independent exercise of agricultural activity
Tax on personal income derived from independent exercise of economic activity
Tax on personal income derived from independent exercise of professional activity
Tax on personal income derived from copyrights, patents and technical innovations
Tax on revenue derived from capital and capital rights
Tax on total revenue of citizens
Tax on income of a foreign person engaged in economic and professional activities
Tax on compensation obtained by a foreign person from investments in a domestic organization of associated labour
Tax on income of a foreign person carrying out investment projects
Tax on revenue of a foreign person carrying on passenger and cargo transport

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KOREA:

Tax Reform

Seihwa Accounting Corporation*

On 26 December 1988 the Korean Government enacted revisions to Korean tax laws. The revisions generally became effective 1 January 1989. The 8 tax laws and related presidential decrees which have undergone reform are as follows:

- Corporation Tax Law
- Individual Tax Law
- Special Excise Tax Law
- Inheritance Tax Law[1]
- Value Added Tax Law[2]
- Liquor Tax Law[3]
- Telephone Tax Law[4]

This article briefly summarizes several of the amendments.

I. OVERVIEW

A. Corporation Tax Law

The net operating loss (NOL) carry-forward has been extended from 3 years to 5 years. The corporation tax rates remain unchanged. However, income to be taxed at the lowest marginal rate of 20% has been increased from the first 50 million won of taxable income to the first 80 million won of taxable income.

A transfer pricing system has been introduced. The Korean tax authorities can require the concerned taxpayer to submit documents supporting transfer prices, etc. if deemed necessary.

The concept of what constitutes a permanent establishment ("PE") in general has been modified to enlarge the scope of activities deemed to constitute a PE in Korea of a foreign corporation.

Income allocation rules for a foreign corporation engaging in business activities taking place partially in Korea and partially outside Korea have been introduced.

B. Individual Income Tax Law

The income tax rate structure has been simplified by reducing the number of tax brackets from 16 to 8. Top marginal tax rates have been reduced from 55% to 50%. Thus the total top marginal tax rate (including surtaxes) has been reduced from 70.13% to 63.75%.

Personal deductions have been increased.

Income tax exemption opportunities for foreigners have been significantly reduced. Such opportunities have now been eliminated for those expatriate employees of foreign-invested corporations approved under the Foreign Capital Inducement Law ("FCIL") on or after 1 January 1989 as well as for those expatriate employees working in Korea under the terms of a licensing or technical assistance agreement not considered to involve high technology. The exemption continues to be available to foreigners working under licensing and technical assistance agreements deemed to involve high technology.

The 20% tax reduction previously available to foreign residents who declared and paid monthly tax on non-won salaries (Class B earned income) paid by a non-resident corporation will no longer be available in cases where the Class B income is treated as a tax-deductible expense in the Korean corporation tax return of the entity to which the expatriate is assigned.

II. CORPORATION TAX LAW (CTL)

A. Extension of the loss carry-forward period

The new CTL provisions extend the loss carry-forward period from the present 3 years to 5 years for net operating losses incurred in years for which a corporate tax return is filed after 1 January 1989. Thus a 1988 fiscal year NOL can be carried forward up to 5 years in cases where the final return for fiscal year 1988 is filed after 1 January 1989 (Arts. 8 and 53 CTL).

B. Restriction on tax-deductible limit of contributions/donations

Under previous CTL provisions, the following contributions/donations were totally deductible:

- value of money and goods donated to Government agencies and local autonomous bodies without compensation;
- contributions for national defence and war relief;
- value of money and goods donated for the relief of disaster victims.

Under the new CTL provisions, these public contributions are regarded as tax-deductible expenses within the limit of the amount of income earned in a taxable year after deducting available loss carry-overs (Art. 18 CTL).

Under the previous CTL provisions, where a corporation disbursed certain designated donations as defined, the donations were considered tax-deductible to the extent of an amount equivalent to 10% of the taxable income (60% thereof in the case of non-profit corporations) increased by an amount equivalent to 2% of the paid-in capital (with a limit of 5 billion won maximum if the 2% of the paid-in capital exceeded 5 billion won).

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1. Since this law relates primarily to Korean taxpayers it is not discussed in this article.
2. No significant changes have been made to this law so it is not discussed in this article.
3. Id.
4. Id.

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For taxable years beginning after 1 January 1989, the tax-deductible limit of the above-designated donations will be restricted to an amount equivalent to 10% of the taxable income (60% thereof in the case of non-profit corporations) after deducting the total amount of public contributions as well as available loss carry-overs, and an amount equal to 2% of the paid-in capital (with the maximum limit of 5 billion won).

C. Corporate income tax rate

Korean corporate income tax rates are currently as follows:
First 50 million won of taxable income: 20%
Balance: 30% or 33%
Under the new CTL provisions, the taxable income base subject to the 20% income tax rate is increased to 80 million won for fiscal years beginning after 31 December 1988 (Art. 22 CTL).

D. Increase in the special capital gains surtax on disposition of unregistered real property

Currently, the special capital gains surtax rate in the case of disposition of unregistered real property is 35% of the tax base. Under the new provisions, the surtax rate is increased to 40%.

E. Introduction of transfer pricing system

Under current CTL provisions, in the case where an act of a corporation or its calculation of corporate income is considered to unreasonably reduce the tax burden because of transactions with other corporations with whom the corporation has a special relationship, the tax authorities may recalculate the taxable income of said corporation irrespective of such act or calculation of taxable income. However, no specific provisions regulate unfair transfer pricing on international transactions of a multinational company. The new CTL provisions introduce a transfer pricing system to provide methods for determining whether a particular transfer price for goods and services traded between related parties conforms to the arm's length principle as follows:
- comparable uncontrolled price method;
- resale price method;
- cost plus method, etc.

In this regard, Korean tax authorities can require submission of data or supporting documents related to international transactions in order to assess the reasonableness of the transfer pricing. The enactment of the transfer pricing system to regulate intercompany prices is thought to signal that the Korean tax authorities will henceforth put more emphasis on international transactions of multinational companies. Therefore it is recommended that the company carefully establish its intercompany prices associated with its business in Korea in order to minimize the potential tax exposure.

F. Expansion of the scope of permanent establishment (PE)

Previous CTL provisions enumerated the scope of business activities that would be deemed to constitute a PE in Korea of a foreign corporation. The tax authorities believed this definition placed unreasonable limitations on their ability to tax the business income of a foreign corporation operating in Korea. The new provisions redefine the concept of what constitutes a general PE of a foreign corporation in Korea (i.e. a fixed place of business through which the business of an enterprise is wholly or partly carried on), to that which is internationally well-known and used in tax treaties. These new provisions expand the scope of activities deemed to constitute a PE.

G. Introduction of income allocation rules for a foreign corporation's business profits

If a foreign corporation engages in business both within Korea and outside Korea, the business income earned by the foreign corporation may be considered as arising from sources within Korea and within the foreign country. Under the old CTL provisions, however, there was no prescribed method to allocate the foreign corporation's business profits between domestic-source income and foreign-source income and consequently the Korean tax authorities tried to tax in Korea all of the income of the foreign corporation including the income corresponding to the business activities conducted in foreign countries.

The new CTL provisions introduce industry-specific income allocation rules for foreign corporations engaging in business in and outside Korea for the following industry groups:
- manufacturing;
- trading;
- construction;
- insurance;
- publication and broadcasting;
- international shipping;
- international air transport.

The new CTL provides guidelines for income allocation from a theoretical perspective but does not regulate the detailed methods for such allocation. However, the introduction of an income allocation rule would limit the tax authorities' income allocation options and as a result the tax burdens of foreign corporations subject to these provisions should be reduced considerably.

H. Elimination of capital gains tax exemption associated with incorporation of a foreign-invested corporation

Previously, an exemption from capital gains tax (except for defence surtax) was available to the Korean joint venture partner in the case where the Korean partner contributed land and buildings to a newly formed foreign-invested joint venture corporation. This exemption is eliminated from 1 January 1989.

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III. INDIVIDUAL INCOME TAX LAW (ITL)

A. Simplification of global income tax rate structure

The old global tax rate structure consisted of 16 tax rate brackets ranging from 6% to 55%. Under the new provisions, the global income tax rate structure to be applied from 1 January 1989 consists of 8 tax rate brackets ranging from 5% to 50% (Art. 70, para. 1 ITL). Table A summarizes the basic global income tax rates exclusive of defence and resident surtaxes (amounts are in thousands of Korean won):

Table A

Previous law				*New law*			
Annual taxable income				*Annual taxable income*			
Over	*Not over*	*Income tax on Column 1*	*Percentage on excess*	*Over*	*Not over*	*Income tax on Column 1*	*Percentage on excess*
(Column 1)				(Column 1)			
—	1,800	—	6	—	2,500	—	5
1,800	2,500	108	8	2,500	5,000	125	10
2,500	3,500	164	10	5,000	8,000	375	15
3,500	4,800	264	12	8,000	12,000	825	20
4,800	6,300	420	15	12,000	17,000	1,625	25
6,300	8,000	645	18	17,000	23,000	2,875	30
8,000	10,000	951	21	23,000	50,000	4,675	40
10,000	12,500	1,371	24	50,000	—	15,475	50
12,500	15,500	1,971	27				
15,500	19,000	2,781	31				
19,000	23,000	3,866	35				
23,000	29,000	5,266	39				
29,000	37,000	7,606	43				
37,000	47,000	11,046	47				
47,000	60,000	15,746	51				
60,000	—	22,376	55				

B. Increasing personal exemptions and standard deductions from individual income

The new ITL increases certain basic exemptions and deductions (see Table B).

Table B
(amounts are in thousands of Korean won)

	Previous law	*New law*
Basic exemption	300	480
Exemption for spouse	420	540
Exemption for other dependents, per person (maximum 2 children in general)	240	480
Exemption for handicapped persons, per person	300	480
Exemption for old persons, per person	—	360
Earned income deduction	940-1,700	1,400-2,300
Deduction for education expenses of dependents, per person	120 (max. 240)	Fully deductible (up to 2 children)

C. Income tax exemption for foreigners

Previously wages and various allowances received by a foreigner engaged by a foreign-invested company, or a foreigner furnishing services under a technical licence agreement ("TLA") prescribed under the Foreign Capital Inducement Law ("FCIL"), were eligible for a tax exemption. Under the new ITL, effective 1 January 1989, the earned income tax exemption for foreigners engaged by a foreign-invested company approved under the FCIL is abolished. However, foreigners who work at a foreign-invested company for which the foreign investment was approved by the Korean Government *before* 1 January 1989 will still be eligible for the income tax exemption pursuant to the old provisions.

Effective 1 January 1989, the new regulations eliminate individual tax exemption opportunities for foreigners working in Korea under a TLA in all cases except TLAs involving high technologies for which TLA fees and royalties have also been approved for withholding tax exemption. The exemption will continue to be available for foreigners working under TLAs approved by the Government prior to 31 December 1988.

D. Scope of Class B income

The current ITL provisions identify earned income as either Class A or Class B depending on the income source.

Class A earned income is employment income re-

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ceived or accrued from a domestic (Korean) employer for services rendered in Korea. Such income is subject to payroll withholding taxes by the employer or payor on a monthly basis.

Class B earned income is employment income received or accrued in a non-Korean won currency from a foreign employer outside Korea for services rendered in Korea. The employer is not required to withhold Korean taxes on Class B income at the time of payment. Instead, the individual is required to declare this income annually and pay income taxes thereon on a voluntary basis. Alternatively, the individual may elect to pay Class B income taxes voluntarily through a licensed taxpayers' association which collects and remits such taxes on a monthly basis.

Taxpayers who join such a taxpayers' association and meet the monthly payment obligations receive a 20% reduction in the amount of income tax payable.

The new ITL provisions, however, provide that if Class B income is deducted from the taxable income of the Korean PE of the foreign corporation which pays the Class B income (e.g. taxable branch office), this earned income will be classified as Class A earned income from 1 January 1989 regardless of whether the earned income is paid by the foreign corporation or its Korean operation. Therefore, the 20% tax reduction on such earned income accrued from 1 January 1989 is abolished and the Korean operations of the foreign corporation are required to withhold individual income tax on the earned income.

The new tax laws do not specifically prescribe a particular methodology for the withholding or the timing of the withholding. Absent specific guidelines, it appears employers should initiate withholding effective with the January 1989 payrolls; otherwise penalties may apply. Please note, however, that individuals whose employers do not claim the salary/wages as a deductible expense in the Korean corporate tax return can still enjoy the 20% tax reduction as before. Employees who work at non-taxable branches, liaison offices or purchasing offices continue to qualify for the 20% tax reduction.

IV. TAX EXEMPTION AND REDUCTION CONTROL LAW (TERCL)

A. Elimination of tax exemption opportunities for certain foreign capital

Previously, the TERCL provided tax incentives for certain foreign capital. However, new TERCL provisions eliminate the following tax exemption opportunities for foreign capital introduced from 1 January 1989:

- Exemption from corporation income tax, property tax, acquisition tax and special excise tax for a company in which an international financing institution or certain foreign investors (who are partners of such international financing institution) have invested.
- Exemption from income tax for dividends or distribution of retained earnings received by an international financing institution from a foreign-invested company.
- Exemption from income tax on interest and commission income associated with foreign currency loans provided by an international financing institution or a domestic branch of a foreign bank.
- Exemption from income tax for rentals paid in foreign currency in cases where a domestic leasing company leased facilities from abroad.
- Exemption from special excise tax on a domestically-produced passenger vehicle purchased by a foreign-invested company approved under the FCIL for use by foreigners working for that company.
- Exemption from corporate income tax on dividend income received by a holding company established for the purpose of investing in foreign-invested companies under FCIL.
- Exemption of withholding tax on interest income arising from non-Korean won currency-denominated deposits which are repayable in non-won currency if such deposit is made by a non-resident.

To encourage the internationalization of the domestic banking business, a new tax exemption opportunity relative to interest paid and received in connection with offshore financing transactions of domestic foreign exchange banks is available. Previously, the interest income received from a foreigner was subject to Korean corporate income tax.

B. Tax incentives for newly-organized small and medium enterprises

Under the old provisions of the TERCL, in the case where a foreign-invested company was categorized as a "Newly-Organized Small-Medium Enterprise" ("NOSME") as defined by the TERCL, such an enterprise was granted tax incentives under the TERCL in addition to incentives available under the FCIL. However, in the case of NOSMEs incorporated after 1 January 1989, the company must opt for one set of tax incentives and is no longer eligible for both.

C. Increase in overseas investment loss reserves

Under TERCL, a domestic person, including a domestic corporation who has invested in an overseas joint venture with a permit under the Foreign Exchange Control Regulations related to overseas investment, may establish a tax-deductible "overseas investment loss reserve" account. From 1 January 1989 the maximum limit of such a reserve for a fiscal year is increased to 20% (previously 15%) of the total amount of the investment as of the end of the fiscal year.

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D. Classification of wholesale and retail businesses as small and medium-sized businesses ("SMS") eligible for tax incentives

Under current TERCL provisions, a company engaging in any of the following 5 industrial categories can be classified as an SMS (such companies receive certain tax benefits) as long as the company also meets certain criteria related to the number of employees and size of assets as described in the TERCL and Fundamental Law Concerning Small and Medium Industry ("FLSMI"):

- manufacturing;
- mining;
- construction;
- transportation;
- fisheries.

New TERCL provisions stipulate that a company engaging in wholesale and retail business can also be classified as an SMS for tax purposes if the company fulfils certain criteria. Therefore a wholesale and retail company can enjoy various tax incentives related to the SMS classification beginning 1 January 1989.

E. Reduction of tax incentives for export businesses

Export-oriented businesses may be eligible for special depreciation deductions equal to 30% of the normal depreciation of assets devoted to the manufacture of export products. Effective 1 January 1989, however, the special depreciation is available only for small and medium-sized companies engaging in the export business. The previous TERCL provisions also permitted a domestic corporation engaged in the export business to establish tax-deductible price fluctuation reserves relative to inventory held for export. Under the new provisions, these reserves are no longer permitted.

V. SPECIAL EXCISE TAX LAW (SETL)

Under the new SETL provisions, the special excise tax rates for goods which have become popular as individual incomes have increased are significantly reduced from 1 January 1989 as follows:[5]

Taxable item	*Previous law (%)*	*New law (%)*
Jewelry	100	30
Precious metal products	30	10
Fur or skin	100	60
Slot machine, speculation equipment for entertainment and other goods for recreation	100	30
Golf equipment, hunting gun and rifle	100	25
Furniture	15	10
Special cosmetics	20	10
Air-conditioners and related products	40	25
Refrigerator and freezer		
Large	40	20
Small	28	15
Electric washing machine	40	20
Colour television set		
Large	40	20
Small	28	15
Recorders and similar equipment	25	15
Electricity, electric heat and gas appliances	28	15
Automobiles	10-40	10-25
Motorboat or yacht products	40, 60	30
Piano		
Grand type	30	20
Others	20	10
High-grade watch	30	20
Television image, sound recorder and related products	40	25
Film projector, movie camera, high-grade camera and related products	40	25
Television screen projector and screen	40	30
Crystal glassware, bottles, etc.	20	10
Coffee and cocoa and cacao paste		
Coffee and cocoa	40	20
Cacao paste	20	10
Sugar	30	10
Soft beverage	20	10
Taste beverage	25	10
Nutrition preparations and stimulants	20	10
Carpet		
Woollen	40	20
Others	20	10

5. In addition, special excise taxes on billiard tables and equipment, black and white television sets, small recorders, frozen sweets, fermented milk and beverages similar thereto, natural fruit juices and woollen yarn or wool products will be completely eliminated from 1 January 1989.

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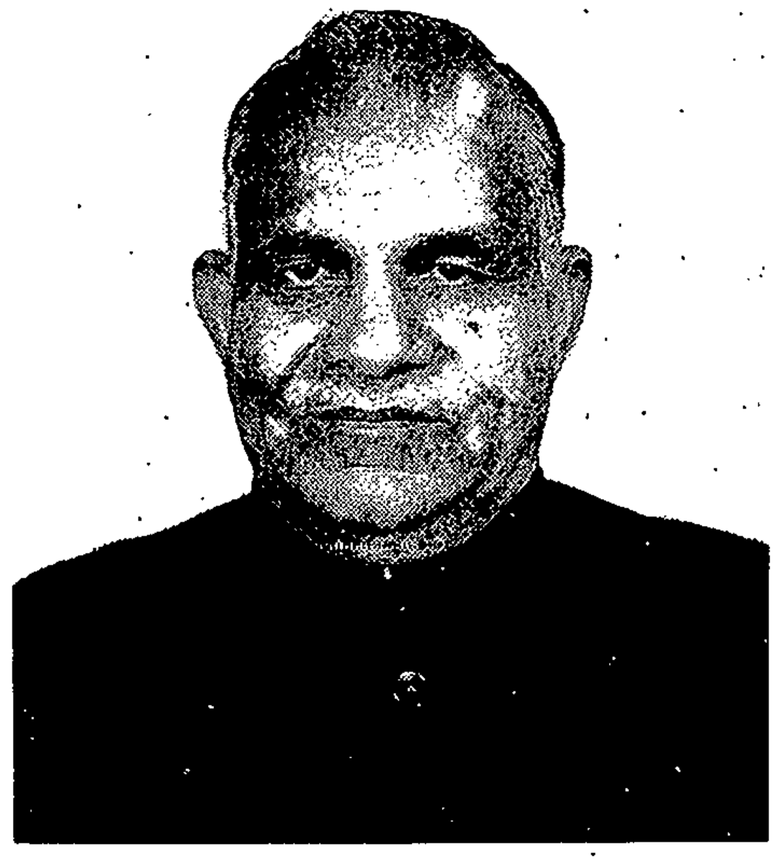
INDIA:

Application of the Law to the Computer Industry

Har Govind



Mr. Har Govind holds a master's degree in science and a bachelors degree in law. He is retired from the Indian Revenue Service where he held the post of Chief Commissioner of Income Tax. Currently, Mr. Govind practices as an advocate at the Supreme Court of India, New Delhi. He was U.N. Consultant on taxation to the Government of Iraq. He is on the Panel of Consultants of both the U.N. and the World Bank. His other assignments include Director of Investigation, Monopolies Commission. Mr. Govind contributes articles to the *Bulletin* and other international tax journals on a regular basis and he has written a book on anti-trust legislation in India.

INTRODUCTION

The coordination of computer and communication technologies assists mankind through a variety of applications. Today, no field of human endeavour, be it industry, commerce, defence, education, energy, entertainment, medicine or space, fails to derive strength and sustenance from these vital branches of technology. Assimilation of data, its analysis and decision support systems all contribute to making the right decision at the right time. The far-reaching use of computers has facilitated improvements in productivity, efficiency, safety and the quality of life.

A developing country like India offers vast opportunities for development of the various associated sub-systems of the computer industry (e.g. peripheral devices[1], software and computer-based systems in which the computer is a major sub-system). One of the primary objectives of India's Seventh 5-Year Plan (1985-1990) is to promote the growth of computer software both for domestic application and export.[2] This article examines some tax and non-tax incentives available in India in relation to the computer industry.

POLICY MEASURES

A series of tax concessions and incentives has been announced by the Indian Government over the past few years.[3] The main features of the computer policy announced in November 1984 include the following:

- Any Indian company[4] may manufacture computer systems (with the exception of 32 and higher bytes super-mini/main frame architecture but including micro-processors of 32 and higher bytes or equivalent CPUs[5], memory and peripheral device controllers completely incorporated in Large Scale and Very Large Scale Integrated (LSI/VLSI) chips.
- All applications are processed by one Government authority, the Inter-Ministerial Standing Committee (IMSC).[6]
- No capacity restrictions (including systems below 3,000,000 Rs. ex-factory value). Existing units may attain higher capacities on the basis of the investment and availability of infrastructure.
- The import of technology by suppliers of CPUs, peripheral devices and sub-systems for original equipment manufacture (OEM basis) is liberalized.
- Imports of designs and drawings, systems/utility software are permitted at the time the original manufacturing unit is set up.
- Software import in the form of source code is encouraged.[7]

1. A device connected to and controlled by the computer.
2. Annual Report for 1987-88 of the Department of Electronics (DOE) of the Government of India.
3. These measures have been provided mainly through the following statements: computer policy of 19 November 1984, integrated policy measures on electronics of 21 March 1985, the Union Budgets 1985 through 1988 and the policy on computer software, export, software development and training of 19 December 1986.
4. Companies with foreign equity up to 40% are also included (see footnote 8).
5. A CPU is the chip which categorizes keyboard and disk drive signals and teaches other components what to do with the signals.
6. The Committee has a separate Secretariat. If necessary the Secretariat consults the Ministries of Industry, Commerce, Finance, etc. The applicant is not required to submit separate applications to each Ministry.
7. Source code refers to the basic code from which various application codes can be developed.

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In the wake of the 1984 computer policy, growth of the industry was faced with numerous obstacles with regard to the import and manufacture of software and the use of this policy to promote software export. As a result a new liberal software policy was formulated which was conducive to long-term growth in software development and export. The main features of the December 1986 policy on computer software are as follows:

- hardware and/or software of computers/computer-based systems for undertaking software export projects may be imported at a concessional customs duty of 60%;
- software export may be carried out via satellite data link;
- a new scheme has been launched by India's Export-Import Bank to provide foreign exchange to software exporters for import purposes;
- computer software can be imported on Open General Licence (OGL) by the actual user, by the computer manufacturer or by the software company for stock and sales at 60% customs duty per copy;
- incentives are granted to software exporters to boost exports;
- only non-FERA companies with a maximum foreign equity of 40% may develop software for the domestic market; companies with a foreign equity exceeding 40% will only be permitted for 100% export projects;[8]
- a foreign exchange allocation of up to 30% of the net foreign exchange earnings in the previous year will be granted to software exporters in order to market their products abroad;
- the DOE and the Department of Education (in conjunction with the University Grants Commission) will set up an Indian Institute of Informatics Technology (IIIT) in 4 regions of the country for the training of computer professionals;
- the Software Development Agency (SDA) has been established by the DOE for implementation of the new software policy;[9]
- a number of incentives will be granted to private sector educational institutions for the training of individuals.

These policies reflect the Prime Minister's concern for development of the electronics industry in general (including computers and associated sub-systems). During the inauguration ceremony of a seminar on Investment Opportunities in Electronics organized by the All India Manufacturers Organisation (AIMO), Mr. Gandhi expressed the view that electronics, which requires low power consumption and minimal pollution risk, is critical for India's growth. He said, "Electronics is really like the nervous system of a nation; and as nations evolve, that nervous system must also evolve."[10]

The Indian computer industry is expanding both in terms of physical output and the range of products introduced on the market. The following figures illustrate the production of mini and micro systems in calendar years 1985, 1986 and 1987:

Year	Numbers (Mini/Micro systems)	Value (Rs. million)
1985	7,500	1550
1986	30,000	2800
1987	46,000	3750

These figures clearly evidence a marked increase both in terms of numbers and value. Certain sectors of the computer manufacturing industry previously reserved to the public sector have now been opened to the private sector. There is a shift from the manufacture of general computers to specialized systems. More enterprises are embarking on the manufacture of systems applicable to areas like computer-aided design (CAD) or computer-aided manufacture (CAM)[11], on-line transaction processing, data logging or acquisition and control. Remarkable progress has also been achieved with respect to peripheral devices. Most demand for these items (e.g. floppy disc drives, Dot matrix printers, line printers, keyboards and motors) is met by indigenous production.

NON-TAX INCENTIVES[12]

Various non-tax incentives are available to the computer industry.

Technology parks

To enhance the export of computer software, the Union Government devised an innovative scheme to establish technology parks for software development.[13] Satellite links will be used to export the software. In the first phase of the project, 3 technology

8. Participation in an Indian industry by a company with foreign equity in excess of 40% is regulated by the Foreign Exchange Regulation Act 1973 (FERA). Such a company is called a FERA company. Stated briefly, software may be developed for the domestic market by Indian companies having foreign equity participation up to 40%. Companies with foreign equity exceeding 40% will only be allowed for 100% export projects. In addition to the FERA constraints, foreign corporations are also disadvantaged under the Income Tax Act (ITA). The income tax rate for foreign corporations is 65%, i.e. 15% higher than the rate applicable to domestic companies. Some fiscal and tax incentives are only available to domestic companies (see text).
9. The SDA processes applications for importing hardware, allocates foreign exchange for initial marketing expenses, processes proposals for setting up computer manufacturing units (including joint ventures) under foreign collaboration agreements and develops procedures to obtain cash support and declaration of software export through satellite links. A data bank on computer software export performance (as well as the indigenous development of software) has been established and data from more than 70 organizations have been compiled.
10. *Economic Times*, Delhi edition of 22 February 1985.
11. CAD programmes are developed for specialists such as architects and engineers; the design itself is shown on the screen. The CAM programme is a specialized computer system used in collecting data and preparing plans and specifications for the manufacture of certain items (e.g. engineering items).
12. These incentives are not exclusively available to the computer industry.
13. Under this scheme, the Government proposes to spend an initial 50 million Rs. for setting up the technology parks. This includes the cost of the earth station. The Overseas Communication Department has been

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parks are to be established at Bhubaneshwar, Pune and Bangalore;[14] in the second phase, one park will be established at Chandigarth.

The software export technology park is a 100% export-oriented project. An entrepreneur may establish such a park as a resource centre to develop software solely for export. The technology park facilities may also be used by subsidiaries of the establishing unit for the purpose of exporting software. The park may be 100% foreign-owned or it may be owned jointly by an Indian firm and a foreign firm. No import licence is required for importing equipment into the technology park.[15]

Software export

Cash assistance for imports, foreign exchange expenditures or cash refunds is provided to software exporters. Some of the most important incentives include the following:[16]

(1) The exporter may use 30% of the earnings derived from software export (in excess of the export obligation) to import new computer systems, software and hardware, in order to augment existing installations. Excess export benefit provisions may be accumulated for a period of 3 years.

(2) Cash assistance in an amount equal to 10% of net foreign exchange earnings is granted.

(3) To enable the exporter to meet foreign promotion expenditures (including foreign tours, setting up foreign offices, receiving orders from abroad, etc.), an enterprise is permitted a foreign exchange allocation up to 30% of its net exchange earnings in the previous year.[17]

(4) In order to export certain commodities from India, an application must be submitted to the Reserve Bank of India. The existing application was considered unsuitable for software export, so the Reserve Bank developed a new form for this purpose; the new form is know as the "softex form".

(5) To encourage entrepreneurs seeking to establish software export facilities (in particular those involving development of application programmes[18]), assistance under the Venture Capital Fund (VCF) scheme of the Industrial Development Bank of India (IDBI) has been made available. Assistance will be granted to finance the cost of fixed assets and operating expenses for development of software packages. Projects under this scheme may involve investments ranging from 5 million Rs. to 25 million Rs. The promoter's minimum contribution is 10% for a venture of 5 million Rs. or less and 15% for ventures of more than 5 million Rs. An unsecured loan will be granted at a concessional interest rate of 6% annually during the development period. Once the product is commercialized and marketed, the interest rate will be increased to 17%.

Other concessions

Other concessions available to the computer industry include:

(1) Capacity restrictions on the organized computer manufacturing sector have been completely removed.[19]
(2) The manufacture of micro or mini-computer systems (except 32 byte super mini or main frame architecture) is open to any Indian company including companies having a foreign equity not exceeding 40%.
(3) Software development and manufacture is classified as an industry and this industry is not subject to zoning policy because it is a hi-tech area.
(4) The import policy for original equipment manufacturers (OEMS) supplying CPUs, peripheral devices and other sub-systems is liberalized.
(5) The "broad banding" of licences[20] for electronics items has been extended to peripheral and semiconductor devices.
(6) The manufacture of certain specified components and consumer goods de-licenced under the liberalization measures for non-MRTP[21] and non-FERA companies (announced on 3 June 1988) is permitted.

Liberal payment for imported technology

The tax for imported royalties is normally limited to 5% for a period of 5 years. If both lump-sum and recurring royalty payments are involved, the maximum payment is limited to 8% of the net ex-factory value of production calculated for a period of 10 years. The Ministry of Industry, Department of Industrial Development, recently decided that while the existing policy for royalty and lump-sum payments will remain in effect, the policy can be relaxed so that the ceiling on these payments does not obstruct acquisition of sophisticated and closely-held technologies.[22]

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given responsibility for operating, maintaining and controlling the satellite earth station which will have on-line recording equipment to record the messages transmitted or received by the station. The Department will levy normal charges for the use of satellite services.

14. A technology park has already been set up by a private group at Bangalore for 100% export to the United States via satellite links. This park is fully operational and the firm has already started exporting software.

15. Equipment may consist of computer hardware, software, satellite communication equipment, test instruments, etc.

16. For a complete list of the incentives, see the compendium issued on 1 July 1988 by the Electronics and Software Development Council, under the Union Ministry of Commerce.

17. All such allocations will be in the nature of blanket permission issued by the Reserve Bank of India. Commissions may also be paid out of this blanket payment.

18. These programmes are developed in order to execute specific tasks.

19. Capacity restrictions are generally in the form of quantity (number or weight) and/or value restrictions.

20. Under the Government's licensing policy, a separate licence is required to manufacture a machine, system or device within certain specified limits. This inhibits diversification of the product range. Broad-banding allows licensing for the manufacture of more than one type of product on the basis of similarity of plant, design process and production facilities. As a result, the manufacturer can choose his products within the overall terms of the licence.

21. See footnote 23.

22. Manufacturers can make use of this provision by making an appropriate representation to the Government. See the Annual Report for 1987-88 of the Department of Industry at 16.

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Freedom from expansion curbs

Under Secs. 21 and 22 of the Monopolies and Restrictive Trade Practices Act 1969[23] large industrial undertakings are subject to expansion constraints. Substantial expansion of existing undertakings or establishment of new undertakings requires prior approval of the Central Government. This process entails many formalities and overcoming objections from business rivals. However, the Government has utilized its power under Sec. 22A to grant an exemption from such approval for industries which are considered to be of high national priority. Consequently, almost all electronics undertakings (except for consumer electronic goods) are exempt from the approval requirements under Secs. 21 and 22. The exemption specifically covers the following items:[24]

- peripheral devices;
- software;
- magnetic tapes;
- hard discs, floppy discs and diskettes; and
- computers.

This exemption is an important concession and particularly helpful to software export undertakings. It allows expansion of a large industrial undertaking in order to undertake a new computer project or expand its existing business. This concession is available until 20 February 1991.

TAX INCENTIVES[25]

As a follow-up to the 1984 computer policy and the new computer software export policy of 1986, a new classification for computer and computer-based systems was introduced in the Income Tax Act 1961 to grant tax concessions and incentives for the manufacture of computers and development of software.[26] The major amendments are discussed below.

Software promotion through free trade zones

Six free trade zones are now operating at Kandla (Gujrate), Santa-cruz (Bombay), Cochin (Kerala), Noida (Near Delhi), Falta (Near Calcutta) and Madras. A new zone is being set up at Visakhapatnam. Of these zones, the 2 at Santa-cruz and Noida are exclusively export-oriented, i.e. they must export their entire output. The Government has recently allowed sales of their production to the domestic market, against a valid import licence, release order or open general licence without any upper limit.

The export units established in these zones are granted the following:

- all clearances, such as industrial licences or foreign collaboration approval, are granted by one governmental authority;
- no import licence is required for importing capital goods or other production materials;
- capital goods and equipment, raw materials and components for purposes of export processing may be imported duty-free;
- exemption from excise duties and other levies on products manufactured in the zones;
- special reduction of local levies, including octroi[27], sales tax and property tax;
- raw materials and components supplied to these free trade zones from the rest of the country are treated as exports and are eligible for all export benefits;
- proposals for 100% foreign ownership units or joint ventures involving majority foreign equity are also considered for establishment in these zones;
- capital invested by foreign investors can be freely repatriated;
- remittance of profits and dividends earned by foreign investors in these zones is freely allowed after payment of taxes.

A 5-year tax holiday[28] is available to all taxpayers in the free trade zones including foreign companies and non-resident non-corporate taxpayers. The profits and gains of newly-established industrial undertakings in free trade zones are not taxable for the first 5 years of manufacture or production. To enable taxpayers in the free trade zones to utilize this benefit for a longer period of time, an amendment has been made to the effect that within 8 years of the commencement of manufacture or production an assessee will be entitled to avail himself of this benefit for any 5 consecutive years at his option within a period of 8 years, beginning with the assessment year in which manufacturing or production is commenced.[29]

To broaden the coverage of this provision, another amendment clarifies the term "manufacture" for purposes of the tax holiday. "Manufacture" includes activities of processing, assembling and recording programmes on any disc, tape, perforated media or other information storage device.[30] This new incentive is geared to earn foreign exchange through undertakings in free trade zones engaged in developing software.[31] This amendment has retroactive effect from the assessment year 1981-82.

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23. This Act regulates the establishment of new and expansion of existing large industrial houses. A large industrial house, also known as a MRTP unit, is defined in Sec. 20(d) of the Act, i.e. it is a unit whose aggregate assets, including the assets of its inter-connected undertakings, are 1,000 million Rs. or more.
24. Notification No. S.O. 65(E) of 21 February 1986, issued under Sec. 22A of the MRTP Act by the Union Ministry of Industry.
25. The tax incentives discussed are not exclusively granted to the computer industry.
26. The amendments were made by incorporating the changes in the ITA through the Finance Acts of 1985-88.
27. Octroi is an entry tax imposed on goods brought into a town or city. It is generally levied by a municipality or similar local authority.
28. ITA Sec. 10A.
29. ITA Sec. 10A, as amended by Taxation Law (Amendment and Miscellaneous Provisions) Act, 1986 with effect from 1 April 1987, i.e. assessment year 1987-88 and subsequent assessment years.
30. ITA Sec. 10A, amended retroactively with effect from 1 April 1988 by Finance Act 1987.
31. See para. 24 of Memorandum explaining the provisions of the Finance Bill 1987.

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Software development through export-oriented undertakings (EOUs)

To further promote the export of manufactured goods, on 31 December 1980 the Government announced a scheme under which 100% export-oriented units can be established in India. Initially, these units were required to export their entire production except for an allowable level of rejects. The EOUs were granted basically the same concessions as those available to units in the free trade zones.[32] The 100% exporting units are now granted the following incentives:

- Permission to sell production in the domestic market against valid import licences, release orders or open general licence, without any upper limit.
- The Ministry of Commerce has granted permission to sub-contract the manufacture of a portion of the goods to a sub-contractor located outside the 100% export-oriented unit.
- The export control order prohibits the export of goods which are needed in India due to shortages or conservation measures. The order is lifted with respect to 100% export-oriented units using imported raw materials.
- Generally, a 100% export unit must execute a performance bond or legal undertaking with the Chief Controller of Imports and Exports of the Central Government in order to avail itself of the special facilities. The unit must also pay some bonding charges. These charges are levied at concessional rates where a group of export units are located in the same area.

A tax holiday for 5 years during the first 8 years of the unit's operation is also granted as in the case of units located in the free trade zones.[33] The benefit of the export-oriented units is also available to all resident and non-resident taxpayers.

New funding scheme for computer industry

Under prior law, an investment allowance of 25% (35% for certain items) of the cost of new plants and machinery was granted to certain specified business undertakings. A new section to the ITA contains a funding scheme to replace the investment allowance.[34] The main features of the new scheme are as follows:

- All business and professional undertakings, including those owned by non-residents and foreign companies, are eligible for funding.[35]
- A deduction of up to 20% of the profits of an eligible enterprise will be granted if the profits are deposited in the Industrial Development Bank of India in an interest-bearing account or if the profits are utilized to purchase new machinery or a plant.[36]

This funding scheme opens up new doors for tax planners. An efficient profit-making enterprise can create additional assets annually of up to 20% of its profits. It can deduct 200% of the cost of machinery from the profit, i.e. 100% under the funding scheme in one year and another 100% as depreciation during the useful life of the asset.

The new funding scheme applies to the electronics industry in general. The scheme does not apply to office appliances but it does apply to computers which have been specifically excluded from the classification of office appliances both in the main text of the ITA[37] and the Eleventh Schedule to the ITA. Consequently, the benefit of this new scheme is also available with respect to computers purchased for office use or manufactured for sale as office appliances.

Investment allowance: provisions amended to include computers

A proposal has been made to reintroduce the investment allowance scheme for selected high priority industries which was discontinued as from 1 April 1987. The revised scheme will be available in place of the funding scheme. The investment allowance will be 20% of the cost of new plants and machinery. Other provisions of the revised legislation will be similar to the previous law.[38] Once a taxpayer exercises the option to accept the benefits under the investment allowance, he may not avail himself of the benefits of the funding scheme for the next 5 assessment years. The necessary legislation with a list of eligible industries is expected to be enacted in the near future.[39]

The old investment allowance scheme was unavailable to manufacturers of certain non-priority articles as listed in the Eleventh Schedule. One group of items in Item 22 of the Eleventh Schedule was office machines and apparatus, which included computers. To provide tax relief for industrial enterprises engaged in the manufacture of computers, the list has been amended so that enterprises manufacturing computers or data processing machines as well as other machines used in the transmission and receipt of messages will be eligible for the deduction under the investment allowance scheme. This amendment will assist computer units in taking advantage of the investment allowance scheme when it is introduced.

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32. Only the income tax exemption was not available to EOUs.
33. A new section has been added to the Income Tax Act to provide for the tax holiday, i.e. Sec. 10B, incorporated in the ITA through Finance Act 1988 with effect from 1 April 1989. This new section will also help units in the development of software even though such units may not be located in a free trade zone.
34. ITA Sec. 32AB inserted by Finance Act 1986, with effect from 1 April 1987.
35. Large scale industrial enterprises, however, are ineligible, i.e. those enterprises carrying on the business of manufacturing or production of any low priority goods or articles specified in the Eleventh Schedule to the Act (e.g. items such as alcohol, tobacco, cosmetics, cameras, office machines, etc.).
36. The purchase of second-hand machinery will also qualify if certain conditions are satisfied. Office appliances (other than computers), machinery installed in offices and guest houses, road transport vehicles and plants and machinery which have been 100% depreciated in the first year are not eligible for the benefits under this scheme.
37. See ITA Sec. 32AB(4). The term "computer" is defined for purposes of Sec. 32AB (4) in an explanation to the section and it includes all computer devices except calculating machine devices.
38. ITA Sec. 32A.
39. Speech of Union Finance Minister of 27 April 1988.

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Partial tax holiday

A "partial tax holiday"[40] is granted to taxpayers establishing certain new businesses which commence production or operation within 9 years following 31 March 1981, i.e. before 1 April 1990. The tax holiday is granted in the form of an exemption of 25% of the profits of corporate taxpayers and 20% of the profits of other taxpayers. To qualify, the new establishment must not have been formed by splitting up or reorganizing an existing business or by transferring machinery or equipment previously used for any purpose.[41]

Eligibility for this incentive is not limited to newly formed entities. It is also available to existing enterprises that set up a new facility unless the new facility merely expands an existing facility. As stated above, the manufacture of computers for use as office machines was previously considered a non-priority item. This situation has changed with the amendment of the Eleventh Schedule and the partial tax holiday is now available.[42]

Full tax exemption for export income

Under the earlier provisions of the ITA[43] an Indian company (including a subsidiary of a foreign company) or a resident taxpayer who exported any goods or merchandise[44] was allowed a deduction not exceeding 50% of the net export profits. This provision was further amended to grant a deduction based on profits as well as the foreign exchange realization. It was equal to the aggregate of 4% of the net foreign exchange realization and 50% of the remaining profits subject to the condition that the aggregate did not exceed the export profits.

Sec. 80HHC has been overhauled to provide that all of the income derived from such exported goods or merchandise is tax-exempt. Both Indian companies and resident taxpayers are eligible for the exemption. Under the previous legislation, supporting manufacturers who did not export goods directly but rather exported through export or trading houses which held valid certificates issued by the Chief Controller of Imports and Exports were not eligible for the deduction. The export-linked deduction has now been extended to supporting manufacturers so long as a proper certificate has been issued by the export or trading house. The amount of the deduction available to the house will be reduced proportionately.

On 27 April 1988 the Finance Minister stated that the provisions of the ITA, which impose a minimum tax on 30% of book profits of zero-tax companies, will be amended in the near future so that the benefit of this export incentive is not denied to such companies.[45] Since the concession of full exemption of export income is only available to resident taxpayers, non-residents and foreign companies can take advantage of this very liberal incentive by entering the export trade through an Indian subsidiary and not directly via a branch office.

Foreign technicians

Foreign technicians employed by an Indian computer firm are entitled to substantial tax benefits. Under previous legislation[46] the remuneration of an approved foreign technician was exempt up to 4,000 Rs. per annum for a maximum period of 24 months. Remuneration exceeding 4,000 Rs. per annum was taxable. If the employer paid tax on the excess remuneration pertaining to the initial 24-month period and on the whole of the remuneration after the initial 24-month period, the perquisite represented by the tax paid was exempt from further taxation in the hands of the foreign technician, i.e. he was not required to pay tax on tax. The latter exemption was available for a further 24-month period so the total tax-free remuneration could be availed of for 48 months.

The 24-month exemption scheme has now been abolished and replaced by a standard exemption for 48 months on the tax paid by the employer on remuneration paid to a foreign technician.[47] The amended provision applies to foreign technicians employed on or after 1 April 1988. There is no tax on tax on the tax-free salary of a foreign technician employed by an Indian concern under an agreement approved by the Government.

R & D expenditures

The ITA previously contained liberal provisions for tax relief in respect of expenditures incurred for scientific research.[48] Expenditures for scientific research are now granted under 2 other sections of the ITA[49] which treat the deduction more or less on par with other expenses and donations. This is a retrograde

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40. ITA Sec. 80I.
41. Reconditioned machinery or equipment imported from abroad is considered as new for this purpose if it satisfies certain conditions.
42. The partial tax holiday is not available for calculating machines and devices.
43. ITA Sec. 80HHC before it was amended by Finance Act 1988.
44. The export of mineral oil, minerals and ore was excluded from coverage.
45. The Finance Minister also announced the amendment of ITA Sec. 115J.
46. ITA Sec. 10(6)(viia).
47. ITA Sec. 10(6)(viia), as amended by Finance Act 1988.
48. For example: Revenue expenditures incurred by a taxpayer for scientific research relating to his business were deductible in computation of taxable profits. Revenue expenditures incurred for payment of the salary of research personnel or for material inputs for the 3 years immediately preceding commencement of the business were regarded as having been incurred in the year preceding commencement of the business and hence qualified for a deduction against taxable profits in that year.
All capital expenditures (excluding the cost of land) for scientific research related to the taxpayer's business were allowed as a deduction in the year in which the expenditures were incurred. Capital expenditures incurred for scientific research relating to the taxpayer's business for the 3-year period immediately preceding commencement of the business were considered as having been incurred in the year preceding commencement of the business and accordingly were allowed as a deduction in computing taxable profits of that year.
Payments made to approved scientific research associations, universities, colleges or other institutions for scientific research were deductible in computing taxable income.
49. ITA Secs. 38 and 80G.

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step, particularly in the sophisticated and rapidly changing arena of computers. The old provision should be restored with appropriate safeguards.

Advanced countries like the United States, Japan and the Soviet Union are far ahead of India in the field of computers. They are manufacturing respectively, the Cray-XMP, the SX-2 and the ELBROS systems of super computers.[50] India can catch up with these countries only by engaging in well-organized scientific research backed by incentives. According to some estimates, the annual world trade in computers is expected to be US$ 100 billion in 1990 and about US$ 300 billion by the year 2000. More than half of this trade is and will be in software. These global trends are encouraging and offer India a good opportunity to develop computers and computer software with the assistance of scientific research and foreign collaboration.

Customs and excise duty

The Government's policy with respect to customs and excise duties applicable to electronic goods generally aims to reduce the input cost as much as possible and to infuse a controlled amount of competition into the industry so that the benefits are passed on to the ultimate consumer and the price of the equipment for the end user is reduced considerably. Keeping this general policy perspective in view, the Government has developed a new package of reduced customs and excise duties.[51]

Currently, computers, computer systems and peripheral devices attract varying rates of customs duty ranging from zero to 147.5%. The Finance Minister recently stated that, as a rationalization measure, a uniform rate of duty of 80% ad valorem plus countervailing duty will be imposed in respect of all computers, computer systems, peripheral devices and spare parts. Software will continue to attract the existing rate of customs duty at 60% ad valorem. As an export incentive, accompanying computer software and start-up spares imported under the policy on computer software export, software development and training will be allowed at the rate applicable to hardware. Computerized numerically-controlled systems and their parts currently attract 80% customs duty. This rate will be reduced to 55% ad valorem. Excise duty on computerized numerically-controlled systems will be reduced to 5% ad valorem.[52]

Currently, excise duty of 10% is levied on the manufacture of computers (including CPUs and peripheral devices). The Finance Minister has announced a proposal to exempt computer software from excise duty.

CONCLUSION

The existing tax and non-tax concessions available to the computer industry are quite attractive. They should be made use of by timely compliance with statutory and procedural formalities. The introduction of computers in the agricultural, educational, industrial and railroad sectors, as well as the modernization programme, all herald a promising future for the computer industry in India.

50. *Hindustan Times*, Delhi edition of 17 October 1988.
51. NEP Appendix I at 41.
52. Para. 161 of the 1988 Budget Speech.

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UNITED STATES:

Investment in the United States:

A Summary of the Technical and Miscellaneous Revenue Act of 1988 and the Sec. 482 White Paper

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The Technical and Miscellaneous Revenue Act of 1988 (the Act) was signed into law on 10 November 1988. The Act amends and clarifies certain provisions relating to the Tax Reform Act of 1986. Many of the provisions have retroactive effective dates, generally effective for taxable years beginning after 1986. A summary of certain of the key international tax provisions is presented in the following paragraphs.

WITHHOLDING TAX ON FOREIGN PARTNERS

The Act repeals the requirement to withhold on actual distributions to foreign partners. Instead, withholding is imposed on partnership distributions in an amount equal to U.S. tax on foreign partners' distributive shares of effectively-connected income. This provision is effective for taxable years beginning after 31 December 1987. In addition, the Act specifically states that no withholding of tax is required for years beginning prior to that date.

The mechanics of this provision are to be dealt with through regulations, although the withholding tax rate required to be used is the highest rate to which each foreign partner is subject. It is unlikely that the regulations will allow losses of one partnership to offset income of another when determining the amount of withholding. It is anticipated that the regulations may contain provisions similar to the effectively-connected income (ECI) election detailed in Revenue Procedure (Rev. Proc.) 88-21, I.R.B. 1988-15. That election required the partnership to make estimated tax payments on behalf of the foreign partner, based upon the partner's share of the partnership's U.S. effectively-connected income. The payments were required to be made quarterly, no later than the estimated tax payment date for the foreign partner. However, since the provisions are in the statute as a withholding tax as compared to an estimated tax payment, the Internal Revenue Service (IRS) may adopt a different approach.

INTERACTION OF TREATIES AND STATUTES

The Act clarifies that neither a treaty nor a statute has preferential status per se. The Act provides no operative rule of interpretation. When the relationship of a treaty and a statute must be determined, the ordinary rules of interpreting the interaction of statutes and treaties must be applied.

The Act lists the provisions of the '86 Act that, in certain instances, do not apply, to the extent their application would be contrary to any income tax treaty obligation in effect on the date of enactment of the '86 Act (22 October 1986), including the following:

- effectively-connected treatment of certain gains from the sale of U.S. business assets after cessation of the trade or business;
- sourcing of "excess interest" under the branch level interest tax;
- application of new operating provisions relating to the second level withholding tax; and
- sourcing of gain on sale of personal property by treaty country residents.

The Act expressly provides that the following provisions of the '86 Act override any preexisting treaty provisions:

- foreign tax credit limitations; and
- limitation of the alternative minimum tax foreign tax credit generally to 90% of the pre-credit alternative minimum tax.

The Act provides that if a taxpayer takes a position that a U.S. treaty overrides or otherwise modifies an Internal Revenue law, that position must be disclosed in the taxpayer's tax return. Failure to disclose could result in a penalty of up to US$ 1,000 (US$ 10,000 in the case of a C corporation) for each failure. The IRS can waive the disclosure requirement or the penalty in appropriate cases. This provision applies for taxable years with returns due (without extensions) after 31 December 1988.

BRANCH PROFITS TAX AND BRANCH LEVEL INTEREST TAX

The Act clarifies the definition of dividend equivalent amount (DEA) by limiting it to post-1986 accumulated effectively-connected earnings and profits not previously remitted to the branch's home office. Also, the DEA does not take into account effectively-connected earnings and profits attributable to the increase in earnings and profits of certain property and casualty

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insurance companies under the discounting fresh-start method. Earnings and profits arising from an unearned premium reserves adjustment are excluded from the DEA.

The Act provides that interest paid by a U.S. trade or business of a foreign corporation is treated as U.S.-source for all income tax purposes. Regulatory authority is granted the Treasury to limit the withholding on interest paid by the U.S. branch to the amount of interest reasonably expected to be deducted in arriving at the branch's effectively-connected income.

The Act provides that where a foreign corporation is treaty shopping, the branch profits tax is imposed regardless of whether a treaty with the country of residence of the foreign corporation allows the United States to impose its withholding tax on dividends. The treaty shopping prohibition on foreign corporations applies to deny benefits under the treaty of the country in which the payor foreign corporation is a resident with respect to interest paid or deducted by its U.S. trade or business. The recipient of the interest, however, is entitled to claim treaty benefits with respect to the treaty of the country in which the recipient is a resident, unless the recipient is treaty shopping as well. A corporation is considered to be treaty shopping if non-residents of a treaty country who are not U.S. persons own 50% or more (as compared with more than 50% under prior law) of the value of the stock. The publicly traded exception is modified to treat a foreign corporation wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States as a qualified resident of its country of residence.

The Act provides that the second level withholding tax on dividends does not apply with respect to dividends paid out of earnings and profits attributable to a year in which the branch profits tax was imposed. Essentially, the second level withholding tax now applies only to dividends attributable to pre-1987 earnings and profits and post-1987 earnings and profits when the branch profits tax is prohibited by treaty.

SUPER ROYALTIES

The Tax Reform Act of 1986 enacted new provisions regarding the transfer of technology and certain other intangible property between related parties. Generally, the provisions require that when such intangible property is transferred between related parties, a royalty must be paid commensurate with the income generated from the intangible (a super royalty). The Tax Reform Act of 1986 stated that the provisions were effective for taxable years beginning after 31 December 1986, but only with respect to transfers or licenses granted after 16 November 1985. The Technical and Miscellaneous Revenue Act of 1988 (the Act) modified this effective date for "inbound" transfers of intangibles.

The Act states that in the case of transfers and licenses of intangibles which are not to foreign persons (inbound or totally domestic) the effective date will still be for taxable years beginning after 31 December 1986, but only with respect to transfers or grants after 16 August 1986, instead of 16 November 1985. Congress thought that this change was necessary because the House version of the Tax Reform Act of 1986 was not clear as to whether the super royalty rules would be applicable to inbound transfers. Their application to inbound transfers was clarified in the Final Conference Committee Decisions released on 16 August 1986.

Amended 1987 tax returns may have to be filed for "excess" royalty payments made by U.S. taxpayers on technology transferred between 17 November 1985 and 16 August 1986.

BANK ACCOUNT INTEREST

The Act restores the exemption from estate tax for bank and certain other deposits where the interest on the deposits is not effectively-connected to a U.S. trade or business. This is effective for taxable years beginning after 31 December 1986.

ESTATES OF NON-DOMICILED ALIENS

Effective for deaths on or after 11 November 1988, the U.S. federal estate tax rates now applicable to the estates of U.S. citizens are extended to the U.S. estates of foreign individuals who are not domiciled in the United States. Thus, the top statutory estate tax rate applicable to the estates of non-domiciled aliens is increased to 55% on cumulative taxable transfers in excess of US$ 3,000,000. Under prior law the top estate tax rate was 30% on taxable estates over US$ 2,000,000. As under prior law, taxable gifts by non-domiciled aliens are subject to the same unified tax rates (up to 55%) that are applicable to taxable gifts of U.S. citizens.

The Act also modifies the unified credit, which exempts the first US$ 600,000 of a taxable estate from estate taxation. If the United States is required by treaty to grant the unified credit to non-domiciled aliens, the allowable credit is based on the portion of an estate that is situated in the United States. In other cases, the estate of a non-domiciled alien is allowed a credit which exempts the first US$ 60,000 of the U.S. estate taxation, the same exemption as under prior law.

Effective for deaths on or after 11 November 1988, property that passes from any estate to a surviving spouse who is not a U.S. citizen is not eligible for the estate tax marital deduction. However, the Act provides that property passing to a surviving spouse through a "qualified domestic trust" is eligible for the marital deduction. Under prior law, all property that passed to a surviving spouse qualified for the marital deduction.

A trust must meet certain requirements to be a qual-

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ified domestic trust, including the following:
- the trust instrument must require that all trustees be U.S. citizens or domestic corporations; and
- the surviving spouse must be entitled to all of the trust income, payable at least annually.

Estate tax is imposed on distributions of corpus from a qualified trust and on the value of the property remaining in the trust on the date of death of the surviving spouse.

MISCELLANEOUS

- clarifies that certain U.S. corporations upon liquidation into their foreign parent can recognize losses as well as gains on the distribution of property, and that if gain is recognized on a distribution of property in liquidation, the foreign parent receives an increase in basis, effective for liquidations and distributions after 31 July 1986, subject to the '86 Act transition rules;
- provides that a tax-free organization transfer of property to a foreign corporation is treated the same way as a liquidating transfer to an 80% foreign corporate distributee (unless the foreign corporate transferee is 80% controlled by a domestic corporation or by members of the same affiliated group), effective for exchanges after 20 June 1988;
- exempts from net-basis U.S. income tax the branch profits tax, the branch level interest tax, and portfolio interest from U.S. Government obligations received by banks organized and doing business in any U.S. possession, effective for taxable years beginning after 31 December 1988;
- exempts certain gambling winnings of non-resident aliens from the 30% withholding tax, effective for winnings after 10 November 1988;
- provides that amounts received as a scholarship or fellowship for study, training or research at a U.S. educational institution by a non-resident alien are subject to tax on a net basis and are also subject to a 14 % withholding tax for non-degree as well as degree candidates, which is creditable against the ultimate net-basis tax, effective for taxable years beginning after 31 December 1986, in the case of scholarships and fellowships granted after 16 August 1986.

THE SEC. 482 WHITE PAPER

On 18 October 1988, the IRS issued its findings and recommendations regarding its study of intercompany pricing – the so-called Sec. 482 White Paper.

OVERVIEW

While a full analysis of the meaning and ultimate impact of the concepts contained in the White Paper will be years in coming, a number of initial observations have begun to crystallize.

There are 5 key recommendations outlined in the IRS study:

1. At the time a tax return is filed, the taxpayer should have contemporaneous documentation on how the intercompany transfer prices were determined.
2. The IRS should aggressively assert penalties for failure to have this contemporaneous documentation or for any significant mispricing.
3. The IRS should more aggressively pursue pricing information through use of administrative summonses, Sec. 982 formal document requests, and through the early involvement of IRS economists and counsel in appropriate cases.
4. A revised methodology should be adopted for determining the appropriate transfer price in goods transactions that involve intangibles. Such methodology would also provide for appropriate pricing readjustments over time.
5. The rules for acceptable cost-sharing agreements should be made more specific and provide for a required "arm's-length buy-in" charge where there is preexisting unshared research.

Perhaps the most important aspect of the White Paper is its IRS issuance. This signals a substantial renewed interest in international transfer pricing, which is likely to be translated into much greater IRS examination activity of the area. In public comments, the IRS has stated that it anticipates releasing regulations reflecting the concepts in the White Paper shortly after the 15 February 1989 deadline for written comments. This signals both the firmness of the present IRS view as embodied in the White Paper and the importance of prompt taxpayer reaction to the White Paper proposals if they are unacceptable.

Even though the White Paper was prepared in response to a congressional recommendation made in conjunction with the enactment of the so-called super royalty provisions on the transfer of intangibles and was supposed to focus on intangibles pricing, it actually covers the transfer pricing of both tangibles and intangibles under its methodology. An abbreviated summary and some observations follow.

PRICING OF INTANGIBLES

The IRS generally addresses 3 methods: (1) the exact comparable method; (2) the inexact comparable method; and (3) the "basic arm's-length return method" (the "ballroom" method).

Use of the exact comparable method would typically require the taxpayer to show a transaction it entered into with an unrelated party in which, based on a functional and market analysis, the functions performed and the marketplace for the unrelated party were basically identical to those of the related party.

The inexact comparable method would permit use of third-party information upon a showing of very close comparability to the related-party situation. As a practical matter, it appears that the use of "comparables"

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would be so restricted under the IRS view in the White Paper as to make them unavailable in most cases.

The basic arm's-length return method estimates the amount of intangible income as a residual. That is, a functional analysis is performed to determine those economic functions that are measurable (e.g. tangible assets). A rate of return is determined for those measurable functions and the income attributable to those functions is thus directly estimated. Any remaining income is treated as income due to intangible assets. This residual income is then allocated to the owner of the intangible asset.

The direct estimate of the income from tangible assets is derived by assuming that the tangible assets of the company earn the average rate of return earned by "comparable" companies. It is the use of this average rate of return that generally makes the White Paper's approach inadequate for computing reasonable royalties or allocating income to intangibles. The approach, however, may be a useful screening device, along with other factors, for determining when more detailed and specific examination is needed.

Finally, the White Paper implicitly recognizes that when both of the related firms own intangible assets, the basic arm's-length return approach is largely unworkable. In fact, this multiple intangible situation is likely to be far more prevalent, particularly in large cases, than the White Paper appears to realize.

In these cases, the White Paper provides little guidance. It states that when both firms own significant intangibles, division of the intangible profit between the related firms "will largely be a matter of judgment". As demonstrated by the above statement, the White Paper does not give taxpayers a lot of concrete guidance to solidify intercompany pricing.

PRICING OF TANGIBLE GOODS

The White Paper also recommends a revision of the priority regarding which pricing methodology should be used to determine the intercompany price for the sale of goods. The revised priority would treat the use of a comparable uncontrolled price as the preferred methodology. If inapplicable, then use of either the resale price, cost plus, or the "ballroom" method would be applied without any priority. The determining criteria would merely be which method has the best data available and requires the least adjustments.

COST SHARING

The White Paper does address cost sharing, but also hints that cost sharing, in and of itself, will not eliminate the need for an intercompany price determination. Indeed, use of a cost-sharing approach to intangible pricing may merely shift the pricing debate from one over what the appropriate royalty should be to one in which we debate the proper sharing of costs. The following points regarding cost sharing should be noted:

- generally, costs within a 3-digit SIC code must be shared;
- costs must be borne in relation to anticipated benefits accruing to each party;
- costs to be shared must be specifically identified;
- parties to the cost-sharing agreement must receive exclusive geographic rights;
- parties must have reasonable basis for predicting anticipated benefits;
- an "arm's-length buy in" is required for new parties or preexisting research; and
- a contemporaneous binding election with documentation in the return will be required.

OTHER PROVISIONS

The White Paper requires the taxpayer to keep contemporaneous documentation regarding the pricing methodology used, and that documentation must be provided to the IRS if requested in an examination. In addition, the IRS plans to revise Forms 5471 and 5472 to require a description of the pricing methodology used and an attestation that the pricing documentation is available at the time the tax return is filed. At present, it is unclear what this contemporaneous documentation should contain.

Finally, the IRS plans to assess the substantial understatement of tax liability penalty where there is overly aggressive mispricing or a lack of contemporaneous documentation. Indeed, the IRS has indicated that documentation alone may not be sufficient to refute application of the penalty.

CONCLUSIONS

The positions and recommendations in the White Paper:

- fail to recognize that corporate tax departments are usually NOT significant players in pricing determinations (that will have to change);
- fail to recognize that an arm's-length price is not a single specific number, but rather is a price that falls within some realistic range (the proposed new rules represent the attempt by the IRS to further systematize a methodology leading to one specific price);
- will require early involvement of tax economists/Sec. 482 specialists by taxpayers in their pricing decisions;
- will create a more confrontational atmosphere between the IRS, taxpayers and foreign fiscal authorities; and
- ultimately may lead to little difference in the final outcome of intercompany pricing disputes.

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UNITED STATES:

Highlights of the Sec. 482 White Paper

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INTRODUCTION

On 18 October 1988 the Internal Revenue Service (IRS) and the Treasury Department jointly issued a discussion draft, widely known as the "White Paper", on intercompany pricing. It is expected that this White Paper will serve as the basis for the issuance of draft regulations under Sec. 482 after the public comment period has ended.

The White Paper was issued in response to changes made by the Tax Reform Act of 1986 (TRA '86) with respect to the transfer of intangible property between related parties. Specifically, the TRA '86 requires that payments made for the transfer or license of technology shall be "commensurate with the income attributable to the intangible" (the so-called "super-royalty" provision).

The White Paper discusses at length the commensurate with income (CWI) concept and the need for periodic prospective adjustments to the transfer price to reflect significant changes in income generated by the intangible. It examines methods for valuing intangibles through the use of comparable transactions and proposes a new functional analysis approach to pricing. This approach largely abandons the historical arm's length pricing standard and promotes a rate of return methodology that in essence treats the transferee of the intangibles as a contract manufacturer.

The study also proposes the imposition of significant restrictions on cost sharing arrangements. As a result, such arrangements would be limited to manufacturing intangibles associated with an entire product line. Moreover, royalty payments computed under the CWI standard would be required for all pre-existing developed intangibles. The White Paper's impact on cost sharing arrangements and on Internal Revenue Code (IRC) Sec. 936 corporations (U.S. possession corporations) will not be discussed in detail. However, companies having these arrangements should carefully review Chapters 12 and 13 of the White Paper.

Further, the study proposes stringent information reporting and contemporaneous documentation requirements. These compliance requirements would impose significant administrative burdens on taxpayers. In addition, it would provide the IRS with a valuable resource for planning audits and proposing adjustments. Moreover, new penalty provisions may be proposed to ensure compliance with the new reporting and documentation requirements.

COMMENSURATE WITH INCOME STANDARD

With the enactment of the TRA '86, Congress decided to shift the focus from the comparable uncontrolled price concept to a CWI concept for payments associated with intangible transfers. The CWI concept requires a taxpayer to evaluate: (1) the income generated by the intangible; (2) the economic contribution of the parties; and (3) the relative risks of the parties when establishing a royalty rate. It further requires the taxpayer to evaluate these factors on a periodic basis, generally annually, and to adjust the payments for significant changes.

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PERIODIC ADJUSTMENTS

The White Paper requires that transfer payments be modified to reflect substantial changes in the income stream attributed to an intangible and for changes in the economic activities performed or risks assumed by the transferor or transferee. Adjustments are not required to be made more frequently than once a year.

The circumstances under which periodic adjustments would not be required are quite narrow. For example, a taxpayer can only avoid the periodic adjustment requirements on long-term license agreements if the taxpayer has a comparable nonnegotiable contract with a third party and the agreement covers "normal profit" intangibles. "High profit" intangibles must be adjusted periodically unless they have an "exact" comparable. High profit intangibles are not defined by the White Paper, but examples such as an AIDS vaccine or cure for the common cold are noted as appropriate examples.

Alternatively, if the taxpayer can demonstrate that the increased income stream generated by the intangible was caused by: (1) events that occurred subsequent to the license; *and* (2) the license contained no provision to adjust for such increased profitability nor would unrelated parties have included such a clause; *and* (3) the profitability was unanticipated (i.e. a competing pharmaceutical manufacturer loses market share due to its product's unanticipated side effects), periodic adjustments can be avoided. A periodic adjustment may also be avoided if the taxpayer can demonstrate that the increased profitability is primarily due to activities performed, and economic costs and risks born by the other party. The burden of proving that any of these exceptions apply rests with the taxpayer. It is apparent from the examples noted in the White Paper that the above exceptions will be very narrowly applied.

The White Paper notes that any changes made to a royalty arrangement may only be applied prospectively by a taxpayer. The IRS, however, is not required to use multi-year set-offs. As such, the IRS can potentially adjust royalties upward for high income years without adjusting them downward for low income years. No relief provisions are provided for either a substantial overstatement of royalty payments by a taxpayer due to subsequent events nor for the above potentially inequitable IRS assessment position. Therefore, it is essential that all royalty agreements be reviewed annually to ascertain whether or not an adjustment in the royalty rate is warranted.

Agreements providing for lump-sum payments will be recast as open transactions. The full amount paid, however, will be recognized as income by the transferor upon receipt. The lump-sum payment will be treated as a prepayment for future royalties. A royalty stream will be imputed annually under the CWI standard. The prepayment will be increased by a "time value" return on investments and then decreased for the imputed royalty. Once the prepayment is fully absorbed, the transferor will recognize imputed royalty income until such time as the intangible has no value. There are no provisions to allow the transferor to reduce the amount of income recognized on the intangible if the lump-sum payment is determined to be excessive.

The White Paper disclaims any intention to convert all sales into royalties, but offers no safe harbor rule that would preclude the IRS from applying the CWI standard to a contract of sale.

METHODS FOR VALUING INTANGIBLES

The White Paper continues to support the use of comparable uncontrolled transactions as a guide for setting arm's length royalties between related parties. It notes, however, that taxpayers in the past have abused this method by using transactions that are not truly comparable. The White Paper therefore attempts to narrowly define the concept of comparability. It then offers alternative methods for computing a proper royalty stream using a functional analysis approach which is based upon the relative economic contributions of the related parties. The White Paper notes that these new methods are required to comply with the CWI standard mandated by Congress in 1986.

To implement the requirements of the CWI standard, the White Paper recommends the following 4 methods: exact comparable; inexact comparable; basic arm's length rate of return (BALRM); and BALRM with a profit split.

Exact comparable

This method requires that the same intangible be transferred to an unrelated party under substantially similar circumstances. Comparability must be tested for *both* external and internal standards.

The external standards require that the transactions take place in similar economic environments. Factors that are considered in determining whether the economic environments are similar include: the size and level of economic development of the markets, the level of other transactions between the parties and the level of economic risks being assumed and the functions performed by the respective parties.

The internal standards require comparability of the contractual aspects of the license agreement. These include such items as the terms of the transaction, the level of services to be provided or collateral obligations to be performed by the parties.

The White Paper notes that it is expected that this method will most likely apply to the transfer of a relatively "common" product that includes intangibles that are widely available (such as the technology incorporated in microwaves or digital watches).

The comparable standard required for intangibles is substantially more stringent than the comparable uncontrolled price standard used for transfers of tangible

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property. For instance, there are no provisions to adjust for differences that have no impact on price, or that can be reasonably measured.

Exact comparables will not require periodic adjustments unless they are required under the terms of the agreement. Exact comparables can, however, lose their comparability over time. As such, these agreements will also require periodic reviews.

If an exact comparable is found to exist, this method *must* be used to determine the related party arm's length price. If there are no exact comparables, one of the other 3 methods must be utilized. There is no ranking or order of preferability among the other methods nor are there any safe harbors. Facts and circumstances dictate which one of the other methods is appropriate.

Inexact comparable

The White Paper defines an inexact comparable as a transaction for which a comparable transaction exists, but such comparable does not meet the standards required for an "exact" comparable.

An inexact comparable may only be used as a guide in setting royalties if the differences between the transactions can be reflected in (1) a reasonable number of adjustments, and (2) the adjustments have a definite and ascertainable impact on the terms. An example of a quantifiable adjustment might be the requirement to provide 100 hours of training or product orientation. The White Paper notes that the use of inexact comparables will *not* provide conclusive results. As such it will generally be inappropriate to base transfer prices solely through the use of inexact comparables.

Based upon the strict limitations placed on the use of comparables, it appears that this standard for valuing intangibles will generally be replaced by the BALRM or the BALRM with a profit split, as hereinafter described.

Basic arm's length rate of return (BALRM)

This method (sometimes referred to as the "Ballroom" method) requires that a functional analysis be made. This analysis attempts to apportion the income derived from a transaction to the functions performed by the parties, and then allocate the "residual" income to the intangible. This residual income is then assigned to the party providing the intangible.

The steps that will be needed to perform a functional analysis will generally include: (1) a breakdown of the business into its component functions or activities; (2) a measurement of the tangible assets or other economic factors used in performing these functions; (3) identification of the rate of return that an unrelated party would earn on those assets or factors; (4) application of the rate of return to the assets or factors to determine the profit appropriate to the functions being performed (the use of the ratio of income to operating costs is suggested if asset data is not available or significant); and (5) the allocation of any residual profit to the owner of the intangible.

Functional analysis will therefore attempt to first assign income to tangible activities performed by the parties (i.e. manufacturing, distribution and marketing) based upon an arm's length rate of return applied to a supposedly measurable factor, and then will attribute the remaining income to the intangible.

This approach will focus controversy on such issues as: (1) the valuation of assets used in performing a function, i.e. use of fair market value versus net book value and, (2) the amount of the arm's length rate of return that is appropriate, i.e. industry average, industry median. In addition, there is the overall issue as to whether this is just a disguised contract manufacturing analysis, a methodology that has been repeatedly disallowed by the courts.

It is expected that the controversy surrounding the valuation of intangibles will continue under this method as IRS agents seek to obtain greater residual values (assuming outbound transfers) and taxpayers seek to allocate income to tangible assets.

Basis arm's length rate of return with profit split

The White Paper notes that the BALRM will not resolve transfer pricing issues when either the intangible is unique (i.e. it has no comparable) or both parties contribute substantial intangibles to the transaction. Under this scenario the White Paper recommends that BALRM still be applied to those functions which have measurable factors. The residual income, however, would be split between the parties based on the relative value of their respective intangibles. The profit split would necessarily be applied using judgmental factors. The White Paper suggests the use of inexact comparables, assuming they exist, as a guide.

DOCUMENTATION AND COMPLIANCE

The White Paper proposes that taxpayers be required to document the methodology used in establishing their transfer prices for intangibles *prior* to filing their tax returns. In addition, a summary of their methodology and an attestation that the documentation is available would need to be reported on IRS Forms 5471 and 5472. This documentation would also need to be provided to IRS examiners upon audit. The White Paper contemplates that the required documentation would include references to any comparable transactions, rates of return, profit splits and any other information or analyses used by the taxpayer to arrive at its transfer price. This contemporaneous documentation requirement will greatly increase the administrative burden imposed upon companies. It may even require larger companies to employ economists to make pricing decisions and gather up-front documentation.

The White Paper proposes that a review of existing

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penalty provisions be made to ensure they are adequate to cover the proposed reporting and documentation requirements. The White Paper further suggests that consideration be given to imposing either a substantial understatement of tax penalty or a transaction-based penalty for any taxpayer that fails to have a reasonable basis for its transfer price.

OTHER ISSUES

Competent authority

The proposed methods for valuing intangible royalties which do not have exact comparables has not been approved or accepted by foreign taxing authorities. If these authorities do not accept the BALRM methodology they may disallow in full, or in part, royalty deductions taken in their jurisdictions. For those countries that have income tax treaties with the United States, a taxpayer can apply to the competent authority to resolve the issue. Prior to applying for competent authority relief, however, the IRS requires that the taxpayer exhaust all of its administrative remedies in the foreign jurisdiction. This procedure could be very expensive. In addition, if the foreign jurisdiction decides not to accept the BALRM method, and the adjustment is substantial, the case may not be resolved. Moreover, even if it is resolved, many countries do not pay interest on tax refunds. Therefore, the taxpayer will have lost the time value of money on that assessment. Finally, the competent authority approach has been slow and cumbersome in the past. Additional cases will only serve to increase this delay.

Double taxation

As noted above, if a foreign jurisdiction does not accept a taxpayer's method of valuing its royalties, a deduction for that royalty may be partially or totally lost. This could result in economic double taxation.

The present attitude of the Treasury and the IRS is that the foreign tax credit mechanism will eventually ameliorate the problem as foreign earnings are repatriated. This, of course, assumes repatriation (which may not be in the financial interest of the taxpayer), ignores the time value of money during the period of double taxation and assumes the taxpayer will not be in an excess credit position in the United States.

Intangibles incorporated in tangible property

The White Paper notes that intangibles, such as trademarks, are often incorporated into tangible property. These intangibles in the past have not generally been separately valued.

Future transfers of tangible property may require taxpayers to bifurcate the transaction and separately value the tangible and intangible elements. The White Paper also notes that services provided to a related party may constitute a transfer of an intangible.

Lack of safe harbors

The White Paper rejects all proposed safe harbor provisions related to transfer prices. This lack of safe harbors increases the taxpayers' audit risk and subjects them to enormous uncertainty.

CONCLUSION

The White Paper attempts to deal with some of the issues raised by the commensurate with income standard. It also focuses on some of the audit problems faced by the IRS and attempts to deal with those problems by suggesting additional documentation requirements and possible penalties. The study also alludes to other areas of concern including services and the impact of currency fluctuations on the transfer price. The IRS has effectively placed taxpayers on notice that they intend to concentrate on potential transfer pricing issues in future audits. As such, now may be an appropriate time to review and document all transfer pricing policies.

ERRATUM

In the article "The Tax Structure of Botswana" by John F. Due, published in the January 1989 issue of the *Bulletin*, printing errors appear.

Page 9, last line of second paragraph: the year *1985* should be replaced by *1958*.

Page 9, 6th line of third paragraph: the rural population should read *70%*, not *20%*.

Page 14, 3rd paragraph from bottom of right hand column, last sentence: The Zimbabwe retail sales *tax*....

The inconvenience is regretted.

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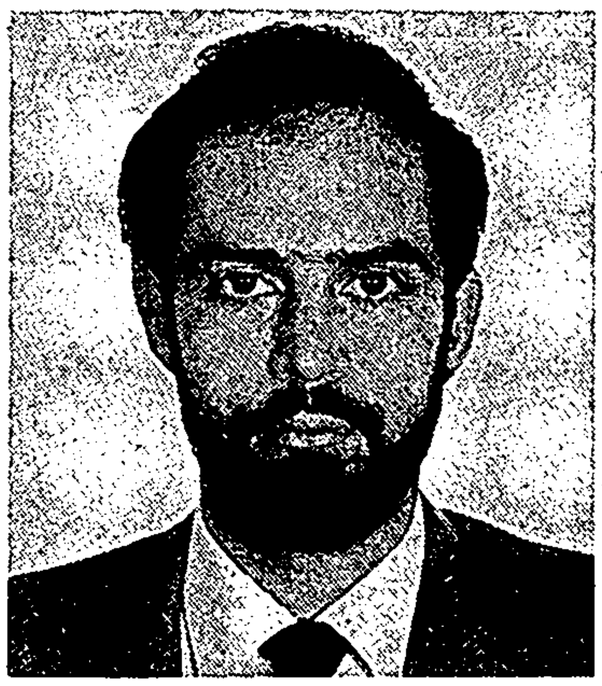

COLOMBIA:

New Tax Measures

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At the end of 1988, the Congress and the National Government of Colombia adopted a series of tax measures.[1] This article summarizes the most important changes made.

Net wealth tax

The Congress granted the President of the Republic "extraordinary powers" (facultades extraordinarias) for a period of 6 months to reduce the rate of the net wealth tax or eliminate it entirely.[2]

Presumption of income[3]

The presumption of income on net receipts was reduced to 1% for the taxable year 1989. As from taxable year 1990, the presumption of income on net receipts will be eliminated and the rate of presumptive income on net worth will be reduced from 8% to 7%.

Bank information obligations

Beginning taxable year 1988, banks and other financial institutions must submit to the tax administration annual reports on individuals or entities having deposits or movements in their accounts which exceed COL$ 120 million (US$ 342,850 at the current exchange rate) per year.

Non-deductible domestic financial expenses

For the taxable year 1988, 14.84% of interest and financial expenses will not be deductible for income tax purposes. For the taxable year 1989, the non-deductible percentage will be similar to that of 1988 if the proportion between the rate of monetary correction and the rate of term deposits remains constant.

Non-deductible financial expenses in foreign currency

For taxable year 1988, 18.89% of the value of adjustments for differences in exchange rates of financial expenses arising from debts in foreign currency shall not be deductible. For taxable year 1989, the non-deductible percentage will be similar provided the proportion between the rate of monetary correction and the rate of external debt remains constant.

Non-deductible financial expenses in 1990, et seq.

The Government has modified the non-deductible percentages provided for in Law 75 of 1986. For taxable years 1989, 1990 and 1991 the non-deductible portion of financial expenses will not be increased. The gradual increase in the non-deductible proportion corresponding to the inflationary component will begin again in taxable year 1992. As from the taxable year 1998, 100% of the inflationary component of interest and other financial costs and expenses, including adjustments for differences in the exchange rate, will not be deductible.

Exempt financial yields[4]

For the taxable year 1988, 20% of the financial yields received by legal entities, including adjustments for differences in exchange rates, will not constitute income or occasional gains. The percentage for the taxable year 1989 will be similar provided the proportion between the rate of monetary correction and the rate of term deposits remains constant.

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1. Decree-Laws 2498, 2633, 2670, 2686 and 2687 of 1988.
2. The net wealth tax is currently assessed at progressive rates from 0.047% to 1.8%.
3. Colombian legislation has established a presumption of income based on the taxpayer's net worth or on the taxpayer's net receipts. The presumption only applies when the regular reported net income is less than the presumptive amount set by law. See *Taxation in Latin America*, International Bureau of Fiscal Documentation, Vol. I, Chapter Colombia, 2.03.
4. Financial yields are the earnings received from investment in current or savings accounts, stocks, bonds, etc., i.e. financial income.

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Depreciation

As from fiscal year 1989 and with respect to assets acquired after 1 January, taxpayers may request a depreciation allowance on the value of any goods adjusted for inflation. The respective accumulated depreciation must be adjusted. Inflation adjustments must be made taking into account the certified increase in the consumer price index for employees during the period between 1 October of the year preceding the taxable year and 1 October of the year before that, as certified by the National Administrative Department of Statistics (Departamento Administrativo Nacional de Estadistica (DANE)). Adjustments and the amount of fiscal depreciation must be registered in the taxpayer's financial statements.

Actuarial computations and deductions for retirement pensions

The technical bases for the elaboration of actuarial computations were modified and, consequently, the deductible value corresponding to future payments of retirement pensions varies considerably.

Bad debts of financial institutions

As from taxable year 1989, the deductible percentage on account of individual provisions for bad debts of financial institutions will be 100% of the value of each debt. For taxable year 1988, a 50% deduction may be requested for debts due for less than one year.

Leasing companies

As from taxable year 1989, leasing companies will be subject to the general regulations on partial non-deductibility of financial expenses and exemption of taxes corresponding to financial yields received by the company. Law 75 of 1986 had excluded leasing companies from such tax treatment. Customers of leasing companies, however, will not be affected by this measure.

Profits of domestic corporations exceeding non-taxable profits

Profits of domestic corporations which exceed non-taxable profits (according to Arts. 21 and 22 of Law 75 of 1986) may also be exempt if they are distributed in shares or taken directly to the capital account, provided the profits arise from inflation adjustments of assets or from the non-taxable inflationary component of financial yields received by the corporation.

Dividends and participations[5] paid to or credited on account of branches of foreign corporations

The tax rate on dividends and participations paid to or credited on account of branches of foreign corporations and which arise from profits derived as from taxable year 1988 has been reduced. The rates are as follows:

Taxable year	Rate
1989	25%
1990	20%
1991	10%
1992	15%
1993	5%
1994 et seq.	0%

Leasing of machinery for international public bids

The income and remittance tax rates for payments abroad on account of leasing of machinery for construction, maintenance or reparation of public works made by Colombian contractors when performing agreements based on an international public bid have been reduced to 2%.

LIFO (Last in first out) accounting

As from 1999, LIFO accounting may not be used by taxpayers.

Sale of shares without taxes

Taxpayers having a net worth of less than COL$ 20 million (US$ 57,142 at current exchange rates) may sell shares of open stock corporations in a stock exchange without tax implications.

Fiscal value of immovable property

For purposes of income, capital gains and net wealth taxes, the fiscal value of immovable property shall be equivalent to 100% of the cadastral value.

Integrated inflation adjustments

According to Decree 2687 of 26 December 1988, as from the taxable year 1992, those taxpayers who are obliged to keep accounting records (with some exceptions) must adopt an integrated system of inflation adjustments for purposes of income and complementary taxes. Inflation adjustments must be reflected in the financial statements and shall be used to determine commercial profits and taxable bases for income and complementary taxes.

Import tax

The Congress extended (up to 31 December 1990) the "extraordinary powers" granted to the President in order to reduce the import tax set forth by Art. 95 of Law 75 of 1986. The tax is currently assessed at a rate of 18% on the C.I.F. value of imports.

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5. Participations are the profits received by partners from limited liability companies as distinguished from dividends received by shareholders from corporations.

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BRAZIL:

The Tax System pursuant to the New Federal Constitution of 1988

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I. INTRODUCTION

The new Brazilian Federal Constitution, promulgated on 5 October 1988, is divided into 9 specific headings and contains 315 articles, including the Interim Provisions. Chapter VI is devoted to taxation and budget issues and is divided into 2 parts. Part I, composed of 6 subdivisions and 15 articles, deals with the Brazilian tax system and is the topic of this article.

The Brazilian tax system is based on the allocation of jurisdiction over tax matters to various governmental entities,[1] i.e. the Federal Government, the States, the Federal District[2] and the municipalities. As a corollary to this division of tax authority, the Constitution established, in some detail, the specific jurisdiction of each political division of the Federal Republic of Brazil.

II. JURISDICTION OVER TAX MATTERS

A. Federal Government

The Constitution provides for exclusive Federal Government jurisdiction with regard to establishing taxes on the following:
(a) import of foreign products;
(b) export of Brazilian products;
(c) income and earnings;
(d) manufactured goods ("IPI");[3]
(e) financial transactions, i.e. credit, foreign exchange, insurance and securities transactions;
(f) rural land;[4] and
(g) large fortunes, pursuant to supplementary law.

The tax rates on imports, exports, manufactured products and financial transactions may be changed by the Executive Branch,[5] with due regard to the conditions and limits established by law.

As a general rule, individuals residing in Brazil are subject to tax on income of any kind regardless of where earned. Income tax will not be levied on income from retirement or pension payments from public security coffers which are received by individuals over 65 years of age if this income is derived solely from past employment.

IPI is non-cumulative and will be assessed according to the nature of the products. IPI is offset against the amount owed for each transaction with the amount charged for previous transactions. IPI is not levied on exports.

The tax on rural land will be assessed at rates intended to discourage the maintenance of non-productive properties. This tax will not apply to small rural holdings (as defined by law) which are worked by the owner's family.

The Federal Government may create other taxes by means of supplementary laws provided that such taxes are not cumulative and provided that neither the taxable events which give rise to them nor the basis on which they are calculated are identical to those already listed in the Constitution. Likewise, in case of a threat or actual occurrence of a foreign war, the Federal Government may create extraordinary taxes. Extraordinary taxes will be phased out when the causes thereof have ceased.

B. States and Federal District

With regard to taxes under the jurisdiction of the States and the Federal District, the Constitution provides for the following:
(a) tax on inheritances and gifts;
(b) tax on transactions involving the supply of goods and rendering of interstate and intermunicipal transportation and communications services ("ICMS")[6] even if the transactions and services are initiated abroad;[7] and
(c) tax on ownership of automotive vehicles.

The new Constitution allows the States and the Federal District to institute a surcharge of up to 5% of amounts paid to the Federal Government by way of tax on income from profits, earnings and capital gains.

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1. The purpose of the specific allocation of jurisdiction is to avoid the same taxes being imposed by different governmental entities.
2. The Federal District is the capital of the Union.
3. Imposto sobre Productos Industrializados. The IPI is the federal value added tax which is levied on manufactured products at the time the products are transferred between producers.
4. Imposto sobre a Propriedade Territorial Rural ("ITR"). This tax is administered by the Ministry of Agriculture.
5. Modifications of the rates will vary in accordance with governmental policy.
6. *Editor's note:* The ICMS is essentially a value added tax.
7. This tax (with the exception of operations related to the supply of goods and services ("ICMS")) previously came under the jurisdiction of the Federal Government.

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The tax on inheritances transfers and gifts involving real property is the prerogative of the State in which the asset is located. In the case of personal property, securities and credit, the State where the probate proceedings or inventory are processed (or where the donor is domiciled) will benefit from the tax. Jurisdiction for creation of this tax must be established by supplementary law in cases where the donor is domiciled or residing abroad, where the deceased was resident or domiciled abroad or where the probate proceedings are conducted abroad. The maximum rates will be established by the Federal Senate.

The tax on transactions related to the supply of goods and interstate and intermunicipal transportation and communications services must be non-cumulative. The amount charged for each transaction will be offset against the amount paid for subsequent transactions by the same or another State. Exemptions or non-assessment of such taxes (except for a legislative determination to the contrary) will not result in a credit to offset the amount due in subsequent transactions or services nor will it cancel the credit granted for earlier transactions. Moreover, this tax can be selective as to the nature of the merchandise or services.

Supplementary law will define the taxable person for purposes of the ICMS, govern the system for offsetting the tax and establish, for purposes of collection, the site of the transactions with regard to the supply of goods and services. Supplementary law may also provide an exemption with credit for export-related transactions, set forth the interstate credit mechanism and regulate the manner according to which (upon State resolution) benefits, exemptions and tax incentives will be granted and revoked.

The rates applicable to transactions and interstate export payments will be established by resolution of the Federal Senate and initiated by the President of Brazil or one third of the Senators, and must be approved by an absolute majority of the Senate. The Federal Senate may establish minimum rates for internal (i.e. intrastate) operations as well as fix maximum rates for internal operations aiming to resolve specific conflicts of interest of the States.[8] The internal rates for transactions related to the supply of goods and services may not, as a general rule, be less than those set forth for interstate transactions.

The interstate rate will be adopted for transactions covering goods and services intended for out-of-State consumers if the recipient pays the taxes. In such a case, the State where the recipient is located will benefit from the difference between the internal and interstate rates. If the recipient does not pay the taxes, the internal rate will be used.

The 1988 Constitution also provides that ICMS will be assessed upon entry of imported goods (even goods intended for consumption or goods constituting fixed assets of the establishment) and upon the rendering of services abroad. The tax will be owed to the State where the establishment which receives the goods or services is located. If goods or services are furnished which do not fall within the tax jurisdiction of the municipalities, the tax will be levied on the total value of the transaction. This tax will not be assessed on transactions involving the transfer of manufactured products abroad (with the exception of semi-processed products as defined by supplementary law) or on transactions in which petroleum (including lubricants, liquid and gas fuels and derivatives) and electric power are sent to other States, or on gold (in cases where gold is defined as a financial asset or exchange instrument).

The taxable base of the ICMS will not include IPI when the transaction between taxpayers and with regard to the product for manufacturing or marketing gives rise to a taxable event.

C. Municipalities

Municipalities may institute taxes on the following:
(a) buildings and urban property;
(b) inter vivos transfers of real property for consideration and in rem rights to real property (except guarantees)[9] as well as assignment of rights to acquisition thereof;
(c) retail sales of liquid and gas fuels (except diesel oil); and
(d) services[10] which are not under the taxing jurisdiction of other levels of government.

The transfer tax was previously an all-inclusive State tax. It will now be divided up among the States with respect to inheritances and divided up among the municipalities for inter vivos transfers of real property. The inter vivos transfer tax, which falls under the jurisdiction of the municipality where the asset is located, will not be levied on the transfer of assets or rights to the assets of a legal entity paying up capital nor will it be imposed on the transfer of assets or rights resulting from the consolidation, merger, spin-off or extinction of a legal entity unless the primary activity of the purchaser is the purchase and sale of such assets or rights, the leasing of real property or leases in general.[11]

The Constitution provides that the tax on buildings and urban property may be levied in accordance with a sliding scale, pursuant to specific municipal law.

Supplementary law will establish the maximum rates for the retail sales tax on liquid and gas fuels (created by the 1988 Constitution) and the ISS. Services exported abroad may be exempted from ISS tax pursuant to supplementary law.

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8. The Federal Senate usually establishes minimum rates for the ICMS. Notwithstanding, the Federal Senate may also establish a ceiling for the rates should a conflict of interest arise between the States.
9. The guarantees *in rem* which are recognized by Brazilian law are the pledge, antichresis, mortgage and fiduciary alienation.
10. Imposto sobre Serviços de Qualquer Natureza.
11. As a general rule, the capital of a company may be increased by an issue of shares or by the capitalization of profits or reserves. In the first instance, shares may be paid up in cash or assets capable of being valued in cash (e.g. real property), in which case the *inter vivos* transfer tax will not be imposed.

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III. DISTRIBUTION OF TAX PROCEEDS

Under the structure established by the new Constitution, the Brazilian tax system should achieve a more equitable distribution of tax proceeds. In accordance with the earlier 1967 Constitution, as amended by Constitutional Amendment No. 1 of 1969, the Federal Government was required to distribute 12% of the proceeds from income tax and the IPI as follows:

(1) 5% to a participation fund for the States and the Federal District;
(2) 5% to a participation fund for the municipalities; and
(3) 2% to a special fund regulated by law.

However, the payment of the funds to the States and municipalities depended on several factors:

(1) approval of the investment programs prepared by each level of government on the basis of guidelines and priorities established by the Federal Executive Branch;
(2) the conditioning of the funds to carry out such programs;
(3) the actual transfer of executive functions of the Federal Government; and
(4) payment of the federal taxes collected as well as liquidation of State and municipal debts (or of their indirect management bodies) including debts arising from guarantees provided to the Federal Government.

The Federal Government exercised strict control over the funds to be distributed to the States and municipalities. Nevertheless, the Federal Government was required to distribute to the States, the Federal District and the municipalities: (i) 40% of the proceeds from taxes on lubricants and liquid or gas fuels; (ii) 60% of the proceeds from the tax on electric power; and (iii) 90% of the proceeds from the tax on minerals in Brazil.[12]

The new Constitution substantially changed the allocation of income tax proceeds among the Federal Government, the States, the Federal District and the municipalities. The States and Federal District are guaranteed proceeds from collection of the federal income tax withheld at source, as well as 20% of the proceeds from collection of any tax instituted by the Federal Government under its jurisdiction. 21.5% of the proceeds from the income tax and the IPI tax will be set aside for a State Participation Fund. 10% of the proceeds from the IPI tax must be passed on to the States in proportion to the value of the export of manufactured products. In any case, no federal unit may receive a portion exceeding 20% of this amount and any excess must be distributed among the other participants.

The new Constitution ensures the municipalities (in addition to proceeds from the federal income tax withheld on income at source in each respective municipality) receipt of the following amounts:

(1) 50% of the proceeds from the federal tax on rural land which is located in the municipality;
(2) 50% of the proceeds from the State tax on ownership of automotive vehicles licensed in their territories; and
(3) 25% of the proceeds from the ICMS. At least three quarters of the 25% will be credited to the municipalities in proportion to the transactions involving distribution of goods and services rendered in their territories with payment of up to one fourth of the remainder being subject to the provisions of State law. 22.5% of the proceeds from the income and IPI taxes will be passed on to a Municipal Participation Fund. In addition, 25% of the 10% of the proceeds of the IPI tax that will be distributed to the States will be passed on to the municipalities with due regard for the same proportional basis used for the ICMS.

3% of the proceeds from the federal income and IPI taxes will also be allocated to investments in financing the production sector in the North, North-East and Central West regions of Brazil through their regional financial programs and in accordance with regional development plans. The drought-stricken North-East area will be assured of half the funds intended for this region, pursuant to the provisions of law. In this manner, 47% of the total federal income and IPI proceeds will be distributed.

According to the Constitution, the Federal Government is forbidden to retain, or in any way restrict, the distribution and use of funds intended for the States, the Federal District or municipalities. However, the Federal Government is not prevented from conditioning payment of such funds to payment of its credits.

Supplementary law will establish additional amounts as well as guidelines for payment and apportionment of funds so as to maintain a socio/economic equilibrium between the States and municipalities. Supplementary law will also provide rules allowing the States, the Federal District and the municipalities to check the calculations of their quotas and the release of their respective participations.

Finally, it should be mentioned that the Federal Government has jurisdiction over the institution (by means of supplementary law) of compulsory loans to meet extraordinary expenses resulting from any public calamity, an actual or imminent foreign war and in the event of a national or local emergency.

Likewise, the Federal Government shall be solely competent to establish social contributions which will be utilized for the benefit of specific professional or economic classes. In addition, the States, the Federal District and the municipalities may make contributions, defrayed by their employees, to provide funds for social security and social assistance programs benefiting the employees.

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12. Distribution of these funds was regulated by federal law and subject to certain criteria regarding the proportion to surface, population, production and consumption in the case of the tax on electric power, and to production in the case of the tax on minerals.

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IV. LIMITATIONS ON THE POWERS OF TAXATION

The new Constitution established a series of limitations on the powers of taxation, thereby ensuring taxpayers of specific rights and guarantees.

The legality principle prohibits all levels of government from creating or increasing taxes except by law. Although this concept existed in the previous Constitution, the principle has been bolstered by abolition of the system of presidential decree-laws. Previously, the Federal Government could collect taxes pursuant to decree-law until the National Congress formally rejected that decree-law.[13] However, the new Constitution allows the President, in case of exigent circumstances, to adopt interim provisions having the force of law. These provisions will lose force of law if not actually converted into legislation, i.e. a formal confirmation by the legislature must be obtained within 30 days of issuance.

Another fundamental principle of tax law – non-retroactivity – is also set forth in the 1988 Constitution. This principle prohibits collection of tax relating to events which took place before the law creating or increasing the tax was passed. The prohibition on the collection of tax in the same fiscal year as the law creating or increasing the tax has a more narrow application. It does not apply to the taxes on imports, exports, manufactured products, transactions involving credit, foreign exchange and insurance, and extraordinary taxes instituted in the event of actual or imminent foreign war.

The principle of equality guarantees non-discrimination between taxpayers in equivalent situations. Finally, a principle not found in the old Constitution but which formalizes the principle of taxpayers' capacity: whenever feasible, taxes will be personal and assessed in accordance with the economic capacity of the individual taxpayer.

V. FINAL COMMENTS

The new system is effective as from 1 March 1989.[14] With the promulgation of the new Constitution, and as a result of the new Brazilian tax system, great emphasis will be placed on the activities of the National Congress, which has considerable legislative work ahead of it to implement the various constitutional provisions. In keeping with the constitutional legislative system, and specifically referring to the Brazilian tax system, supplementary laws will need to cover conflicts of jurisdiction in tax matters between the Federal Government, the States, the Federal District and the municipalities, regulate the constitutional limitations on the powers of taxation and establish general guidelines for tax legislation. Likewise, supplementary laws will need to define the taxes, the factors which give rise to a taxable event and the bases for calculation. Finally, supplementary law must provide for tax obligations, entries, credits, statute of limitations and loss of procedural rights.

13. The decree-laws were effective as soon as issued by the President.
14. Certain provisions, however, were effective immediately after the new Constitution was promulgated, i.e. the provisions dealing with the Federal Government's establishment of compulsory loans and social contributions, and the municipalities' establishment of a retail sales tax on liquid and gas fuels.

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Individual Income Tax in France

Arthur Young International

The extent to which individuals are subject to tax in France depends upon their residency status. Individuals who have their habitual residence or domicile in France are subject to tax on their worldwide income. Under French internal rules, individuals are deemed to be domiciled in France if they have in France at least one of the following:

- their family home,
- their principal place of abode,
- a professional activity, unless it is of an ancillary character, or
- the center of their economic interests.

The above definition of domicile applies to each individual, regardless of citizenship. It is important to note that the tax treaty definition of "resident" overrides the above French internal rules.

Individuals who do not meet any of the above criteria are not considered as domiciled in France and are therefore treated as non-residents for French personal income tax purposes. Non-residents are liable for tax on French-source income only (subject to the provisions of any applicable tax treaties). The amount of French-source income of non-residents is determined according to the same rules that apply to residents. Non-residents who have a place in which to live in France at their disposal (either rented or purchased) are taxed on either 3 times the rental value of the property or on the total of their French-source income, whichever is greater. French-source income is generally taxed according to normal rules (progressive rates and family quotient system) but at a minimum rate of 25%, except for income subject to a specific withholding rate such as interest, dividends and, in some cases, salaries.

Tax treaties concluded by France with other countries typically deny France the right to assess non-residents on the rental value of their French property.

TAX RETURN AND TAX PAYMENT DUE DATES

The French tax year is the calendar year. For French-domiciled taxpayers, tax returns are due by 28 February of the following year. There are various due dates for taxpayers domiciled outside of France:

- Algeria, Tunisia, Morocco, European countries, and the Mediterranean/Black Sea countries – 30 April.
- Africa (except above-mentioned countries) and North America – 15 May.
- Central and South America – 31 May.
- Asia, Oceanic and other countries – 30 June.

Persons domiciled in France are not subject to withholding except on bond interest income.

Payments of tax in respect of the preceding year are due by 15 February and 15 May. Each of these payments is equal to one-third of the taxes paid in the preceding year (i.e. the taxes on income of the next preceding year). The balance must be paid between September and December based on the taxpayer's declaration filed in February. The taxpayer may elect to pay the taxes by monthly installments.

Example:
Assume that the taxes paid during 1988 (based on 1987 income) were 130,000 Ffrs. as follows:

15 February 1988	35,000 Ffrs.
15 May 1988	35,000 Ffrs.
15 September 1988	60,000 Ffrs.
Total	130,000 Ffrs.

In 1989, payments will be required as follows:

15 February 1989	43,333 Ffrs. (⅓ of 130,000 Ffrs.)
15 May 1989	43,333 Ffrs. (⅓ of 130,000 Ffrs.)
15 September 1989	balance of tax on 1988 income

In the case of non-domiciled persons, the taxes due are paid either through withholding or assessments, subject to treaty provisions. The domestic rules impose withholding taxes at the rate of 15% and 25% on salaries. Non-trading profits, services rendered or utilized in France and capital gains on real estate are subject to withholding tax at the rate of 33.33%. Dividends bear a withholding tax at the rate of 25% and interest at a rate from 25% to 51%. Real property dealers are subject to withholding at rates ranging from 15% to 50%.

Some of these withholdings are considered as final (on real estate capital gains, interest, dividends and on 1987 salaries below 142,950 Ffrs.), and the related income does not have to be shown on the tax return. Other withholdings (on non-trading income and on 1987 salaries over 142,950 Ffrs.) are only considered to be an advance payment and may be credited on the final tax due.

PENALTIES AND INTEREST

Various penalties and interest may be assessed by the authorities. In case of an understatement of the amounts reported, interest is due at the rate of 0.75% per month. No interest is due if the understatement is less than 10% of the actual amount to be declared. If the understatement is a result of bad faith or fraud, penalties up to 40%-80% of the tax due on the understatement may be payable in addition to the 0.75% interest.

Failure to file a tax return or material understatements may result in an arbitrary assessment of tax by the tax authorities based on various criteria, such as expenses incurred during the year or on an estimate of revenues

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based on assets owned (external signs of wealth). The taxpayer is then obliged to prove that the amount is too high if he wants to obtain a reduction. In addition, interest is due at the rate of 0.75% per month with an addition at a rate of 10%. After a first formal notice to file from the tax authorities, without answer, this interest is raised to 40% and to 80% after a second formal notice without answer.

Taxes due are increased by 10% in case of late payment.

No penalty or interest is imposed when a taxpayer in good faith discloses in an attachment to his return the position he has taken in preparing the return.

CHANGE OF RESIDENCE

When a person is newly-arrived, he does not have to pay any tax during the year of arrival nor any provisional installments during the following year. Between September and December of the year following the year of arrival, he must pay the total tax relating to the year of arrival.

When a taxpayer leaves France definitively, he has to file a provisional tax return for the year showing the income at his disposal, plus income acquired up to the date of departure even though not realized in cash. The income, determined on a provisional basis, is taxed at the rates in force during the year of taxation. There is a subsequent adjustment when the actual tax rates applicable for that year are later determined.

A provisional declaration should be filed within the 10 days preceding the request for a passport. In practical terms, a few days before the date of departure, the expatriate, who already has a passport, goes to the tax inspector's office which immediately computes the income tax due. The taxpayer then goes to the tax collector's office, pays all taxes due for the year and if necessary for the year before, and receives a clearance certificate ("quitus fiscal").

When necessary, a final amended tax return should be filed at the normal date.

Failure to file a provisional tax return is subject to the same penalties as for year-end tax returns.

GROSS INCOME

The principal categories of individual income are:
- Compensation
- Industrial and commercial profits
- Non-commercial income (i.e., income from professional activities, royalties, fees, etc.)
- Agricultural profits
- Rental income
- Management income (amounts received by managers of certain types of companies who are also majority shareholders)
- Investment income (interest and dividends)
- Capital gains

COMPENSATION

Elements of compensation paid by foreign and/or local employers are taxable in France if they are in remuneration of services performed in France (even if paid outside France). The following items are taxable with exceptions noted below:

Base pay
International service premium
Cost of living allowance
Contribution to profit sharing plan[1]
Bonuses: Relocation bonus
Performance bonus
Employee tax reimbursements
Employee insurance premium reimbursement
Per diem allowance paid on arrival or departure
Relocation allowance[2]
Home leave/vacation allowance/reimbursement
Education for family dependent allowance/reimbursement
Language lessons for spouse
Housing allowance/reimbursement
Furniture allowance/reimbursement
Storage allowance/reimbursement
House protection allowance/reimbursement
Personal automobile provided
Car protection allowance/reimbursement
Car expenses allowance/reimbursement
Sundry fees allowance/reimbursement
Payments in kind

DEDUCTIONS

The French tax system allows certain deductions in computing taxable income:

1. Deduction from compensation:

- Social taxes (i.e. social security, unemployment, retirement taxes).
- A *fixed deduction* of 10% of wages is allowed for professional expenditures. This is the standard deduction for employment income with a minimum deduction of 1,800 Ffrs. and a maximum deduction of 61,190 Ffrs.
- A *deduction* of 20% on the portion of net income (after the above fixed deduction of 10%) not exceeding 554,000 Ffrs. after the deduction for professional expenditure, is also granted if this income consists of wages or pensions.

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1. For U.S. employees, contributions by the employer to profit sharing plans "qualified" under the United States Internal Revenue Code (IRC) are taxable to the employees when, and to the extent that, the payments are considered taxable income under the IRC.
2. Reimbursement of moving expenses, such as payment of the removal of furniture and travel expenses for hotel upon arrival and departure, are not taxable if the expenses are incurred for the needs of the job and not for personal reasons. Payment of a fixed amount to cover so-called "moving expenses" of a personal nature (e.g. one month's salary to get accustomed to a new location) are taxable.

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2. Other deductions:

- Alimony, child support.
- Stock options plan (under certain conditions).
- Charities (with certain limits).
- Private pension plans: contributions to a private pension plan (PER, Plan d'Epargne Retraite) are limited to a maximum of 16,000 Ffrs. per year for married individuals or 8,000 Ffrs. for single individuals, plus 4,000 Ffrs. additional for taxpayers with at least 3 dependent children. Any contributions made within these limits are fully deductible. Investment income from these PERs is exempt from income tax.

COMPUTATION OF TAX: FAMILY QUOTIENT SYSTEM

Taxable income is divided into "units" or shares reflecting the family status of the taxpayer and the number of dependents. Each unit is then separately taxed at the appropriate rate for the income bracket in which it falls. The total tax is calculated by multiplying the tax per each unit by the number of units. Thus, a taxpayer having many units benefits from the lower rates of the tax bracket into which each share falls.

Family status of taxpayer	Number of units
Married or widowed	
Widowed with no dependents	1
Married with no dependents	2
With one dependent	2.5
2 dependents	3
3 dependents	4
4 dependents	5
5 dependents	6
6 dependents	7
Bachelor or divorced	
With no dependents	1
With one dependent	2
2 dependents	2.5
3 dependents	3.5
4 dependents	4.5
5 dependents	5.5
6 dependents	6.5

The amount of tax decrease resulting from the application of the family quotient system is limited to 11,130 Ffrs. per half unit.

TAX CREDITS

Certain credits may be claimed against the gross income tax. Among the more common are the following:

1. Principal residence

Taxpayers owning their principal residence in France are allowed to deduct from their tax liability, under certain conditions, a tax credit corresponding to the interest paid for loans to acquire the property, house resurfacing expenses, heat-saving expenses and major repairs of principal residence.

These tax credits are only granted if the house is used as a principal residence at the time the contract is signed (loans) or the expenses are paid. They can, however, also be granted if the taxpayer undertakes to use the house as a principal residence before 1 January of the third year following the signature of the loan contract or the payment of the expenses.

The maximum amount of these deductions for mortgage interest and house resurfacing expenses is limited annually to 25% of 15,000 Ffrs. plus 2,000 Ffrs. per dependent, including children over 18 electing to be dependents. The deduction of interest on purchase of new buildings is limited to 25% of 30,000 Ffrs. plus 2,000 Ffrs. per dependent (2,500 Ffrs. for the second child and 3,000 Ffrs. for the third one). For heat-saving, the maximum amount is 25% of 15,000 Ffrs. plus 2,000 Ffrs. per dependent.

The tax credit granted equals 25% of major repairs expenses with a maximum of 16,000 Ffrs. plus 2,000 Ffrs. per dependent (2,500 Ffrs. for the second child, 3,000 Ffrs. for the third child and 2,000 Ffrs. for the fourth one).

2. Whole life insurance premiums

These are allowed as a tax credit of 25% of the premiums with a maximum credit of 4,000 Ffrs. plus 1,000 Ffrs. per dependent.

3. Income taxes paid/foreign tax credit

Credits are available for the "avoir fiscal", attached to French dividends, or for withholding tax on bond interest. Credits are also available for foreign taxes paid on foreign-source income taxable in France when provided by tax treaties such as in the case of interest and dividends.

4. Investment in new buildings to be rented for a period of 9 years (the deduction is limited to 40,000 Ffrs. per year for a married couple and 20,000 Ffrs. for a single person).

5. Investment in French stock through a stock savings account ("CEA").

6. Investment in certain recognized show business companies ("SOFICA").

7. Effective for the taxable year 1988, investments in newly created French companies gives rise to a maximum tax credit of 25% of 10,000 Ffrs. (married individuals) or 5,000 Ffrs. (single individual).

[Example of computation on next page]

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Example of French tax computation

Assume the following:
(1) Married couple with 2 children (3 parts)
(2) Full year residents of France
(3) Compensation totals Ffrs. 700,000

Computations

Salary	700,000
Less:	
(A) Social security	
700,000 × 6.4% (max. amt. 7,476)	7,476
700,000 × 5.6%	39,200
700,000 × 2.3% (max. amt. 10,794)	10,794
(B) Pension	
700,000 × 1.88% (max. amt. 2,196)	2,196
700,000 × 2.2% (max. amt. 7,710)	7,710
Adjusted gross income	632,624
Less: Employee deduction for professional expenditures	
632,624 × 10% (max. amt. 61,190)	61,190
Standard deduction for wages	
(632,624 – 61,190) × 20% (max. 110,800)	110,800
Taxable income	460,634

1987: Income tax for 3 parts 135,709
1987: Income tax for 2 parts 164,479

Limitation resulting from the income splitting system 11,130 × 2 = 22,260

1987: Income Tax 167,479 – 22,260 = 145,218

1987 Income tax rates*

Taxable income per unit (in Ffrs.)

From	To	
0	16,560	Nil
16,560	17,320	Nil plus 5% on excess over lower limit
17,320	20,530	38 plus 9.6% on excess over lower limit
20,530	32,460	346 plus 14.4% on excess over lower limit
32,460	41,730	2,064 plus 19.2% on excess over lower limit
41,730	52,410	3,844 plus 24% on excess over lower limit
52,410	63,420	6,407 plus 28.8% on excess over lower limit
63,420	73,170	9,578 plus 33.6% on excess over lower limit
73,170	121,910	12,854 plus 38.4% on excess over lower limit
121,910	167,670	31,570 plus 43.2% on excess over lower limit
167,670	198,330	51,338 plus 49% on excess over lower limit
198,330	225,610	66,361 plus 53.9% on excess over lower limit
225,610 and above	81,064	56.8%

Subsequent to calculating the income tax liability in accordance with the above table, a tax reduction will be allowable as follows:

If amount of tax due is:	*Reduction in tax is:*
23,280 Ffrs. or less	Decrease by 11% of liability
Between 23,281 Ffrs. and 29,090 Ffrs.	Decrease by 11% to 6% of liability at a progressive rate
Between 29,091 Ffrs. and 34,910 Ffrs.	Decrease by 6% of liability
Between 34,911 Ffrs. and 41,060 Ffrs.	Decrease by 6% to 3% of liability at a progressive rate
Over 41,060	Decrease by 3% of total liability to the extent that taxable income does not exceed 304,740 Ffrs. per unit. For taxable income in excess of 304,740 Ffrs. per unit, no tax reduction is available.

* *Editors note:* The figures used in this example are for computation purposes only. The tax rates have changed since 1987.

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D.J. Hasseldine:

DIVIDEND IMPUTATION: THE NEW ZEALAND MODEL **203**
The dividend imputation system recently introduced in New Zealand is the latest measure in a series of reforms covering the taxation of dividends received by individuals. In this article, Mr. Hasseldine paves the way through the labyrinthine legislative provisions. He outlines the full imputation system as set forth in the Consultative Documents, Reports and subsequent legislation; discusses the dividend withholding payment provisions and the interaction of this and full imputation with the branch-equivalent method of the new international tax regime; examines various ancillary tax issues arising from the reforms; and analyzes the implications resulting from the introduction of the imputation system.

Rosemarie Sanderson Schadé:

UNITED STATES: TAX TREATY OVERRIDES IN THE TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 ..... **214**
The TAMRA legislation codifies the "later in time" principle that U.S. tax treaties and domestic tax laws have equal weight and that in the event of a conflict the treaty or law enacted latest in time prevails without the necessity to demonstrate a specific intent of Congress to override existing treaty provisions. TAMRA also enumerates those provisions of the 1986 Tax Reform Act which override contrary treaty provisions and those existing treaty provisions which override the 1986 Act. Finally, TAMRA amends several provisions of the Internal Revenue Code applying to taxpayers who utilize the benefits of tax treaties and imposes new reporting requirements on them. This article discusses the background leading to the enactment of TAMRA and analyzes the TAMRA changes.

Arthur Young International:

INDIVIDUAL INCOME TAXES IN CANADA **218**
Using the United States as a basis for comparison, this article addresses the pertinent elements of the taxation of expatriates in Canada.

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William Cunningham:

PORTUGAL: WITHHOLDING TAXES **223**
With a view to combating tax evasion and shifting the administrative burden from the State to the taxpayer, the 1989 reform places much more reliance on collection of tax at source. This article sets forth the type of payments which attract Portuguese withholding and lists a number of factors applicable to the withholding rules.

Luis Guillermo Morales:

COLOMBIA: THE TAXATION OF INCOME FROM BUSINESS AND CAPITAL: AN OVERVIEW OF OBJECTIVES AND ALTERNATIVES **225**
A commission comprised of international tax experts prepared a report entitled "The Taxation of Income from Business and Capital in Colombia" in order to guide the Colombian Government in the determination on whether and how to modify the inflation adjustment provisions as contained in the 1986 tax reform legislation. The Report describes 2 alternatives: an inflation-adjusted income tax and implementation of a system of direct taxation based on consumption rather that income (simplified alternative tax). This article summarizes the introductory chapter of the Report, describes the policy objectives of a tax system and assesses the merits of both alternatives set forth in the Report.

SRI LANKA: AMENDMENT TO IMPUTATION SYSTEM .. **232**
The recently introduced imputation system in Sri Lanka contains a flaw in respect of individuals who receive qualifying distributions from resident companies, i.e. the legislation only deals with dividends which are qualifying distributions and is silent with respect to dividends paid out of dividends received from other companies. The Commissioner of the Inland Revenue has indicated that the necessary amendments will be made and in the meantime the position will be rectified administratively.

Ian Wallschutzsky:

INTERNATIONAL: ACHIEVING COMPLIANCE IN DEVELOPING COUNTRIES **234**
Developing countries differ significantly in terms of the type of tax systems which can be implemented. This article examines various aspects of an income tax system which affect compliance and over which legislators and administrators have some control.

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D.J. Hasseldine:

Imputation des dividendes: Système appliqué en Nouvelle Zélande *203*
Le système d'imputation des dividendes récemment introduit en Nouvelle Zélande est la dernière mesure d'une série de réformes couvrant l'imposition des dividendes reçus par les personnes physiques. M. Hasseldine tente d'expliquer de façon claire ce nouveau système d'imputation totale tel qu'il est exposé dans les Documents Consultatifs, les Rapports et dans la législation s'y rapportant. Il commente également les dispositions portant sur la retenue à la source des dividendes et l'interaction de celles-ci et de l'imputation totale suivant la "branch-equivalent method" du nouveau régime fiscal international. Il analyse par ailleurs les différents problèmes fiscaux découlant de ces réformes ainsi que les conséquences dues à l'introduction du système d'imputation.

INHALTSVERZEICHNIS

D.J. Hasseldine:

Dividendenanrechnungsverfahren – das neuseeländische Modell *203*
Das vor kurzem in Neuseeland eingeführte Dividendenanrechnungsverfahren ist die letzte Massnahme in einer Reihe von Reformen bezüglich der Besteuerung von durch natürliche Personen bezogenen Dividenden. Herr Hasseldine zeigt in diesem Artikel den Weg durch das Labyrinth der gesetzlichen Bestimmungen. Er beschreibt das Vollanrechnungsverfahren, wie es in den „konsultativen" Dokumenten und Berichten beschrieben und gesetzlich geregelt wurde. Er beschreibt den Quellenabzug von Dividenden und die Wechselbeziehung zwischen diesem Abzug und dem Vollanrechnungsverfahren, sowie die „branch-equivalent" Methode der neuen internationalen Bestimmungen. Er analysiert auch verschiedene hinzukommende Steuerprobleme, die von der Steuerreform verursacht wurden, und die Auswirkungen der Einführung des Anrechnungsverfahrens.

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Rosemarie Sanderson Schadé:

Etats-Unis: Convention fiscale dépassée par la Technical and Miscellaneous Revenue Act de 1988 ..... *214*
La loi TAMRA consacre le principe de la primauté de la loi nouvelle sur la loi ancienne. Les conventions fiscales et les lois fiscales nationales ayant la même valeur aux Etats-Unis, il n'est past nécessaire de démontrer une intention particulière du Congrès pour déroger aux dispositions d'une convention en cas de conflit entre les dispositions d'une convention et celles d'une loi; c'est la loi ou la convention entrée en vigueur la dernière qui prévaut. La TAMRA énumère également les dispositions de la Réforme Fiscale de 1986 qui dérogent aux dispositions contenues dans la convention ainsi que les dispositions contenues dans la convention dérogeant à la loi de 1986. La TAMRA modifie finalement plusieurs dispositions du Code Fiscal s'appliquant aux contribuables qui tirent parti des avantages des conventions fiscales et les oblige à fournir des informations plus détaillées. Cet article commente les motifs ayant conduit à la promulgation de la TAMRA et en analyse les modifications.

Arthur Young International:

Impôts sur le revenu des personnes physiques au Canada *218*
Cette article mentionne les éléments importants sur l'imposition des expatriés au Canada, en prenant les Etats-Unis comme base de comparaison.

Carnet des Congrès *222*

William Cunningham:

Portugal: Les retenues à la source *223*
La réforme de 1989 fait beaucoup plus confiance à la retenue à la source dans sa lutte pour combattre la fraude fiscale et déplace le poids de l'administration de l'Etat vers le contribuable. Cet article présente les formes de paiement valables pour les retenues à la source au Portugal et énumère un certain nombre de facteurs applicable aux règles concernant ces retenues à la source.

Luis Guillermo Morales:

Colombie: L'imposition des revenus professionnels et de ceux tirés du capital: aperçu des objectifs et des possibilités *225*
Une commission composée d'experts fiscaux internationaux a préparé un rapport intitulé "Imposition des revenus professionnels et de ceux tirés du capital en Colombie" afin d'aider le Gouvernement colombien à déterminer s'il était nécessaire et comment il fallait modifier les dispositions d'ajustement pour inflation telles qu'elles se présentent dans la réforme législative fiscale de 1986. Le Rapport offre 2 possibilités: un impôt sur le revenu ajusté sur l'inflation et l'introduction d'un système d'imposition directe fondé sur la consommation plutôt que sur le revenu (impôt de remplacement simplifié). Cet article résume l'introduction du Rapport, décrit les objectifs d'un système fiscal et analyse les mérites des deux possibilités présentées dans le Rapport.

Sri Lanka: Modifications apportées au système d'imputation *232*
Le système de l'imputation récemment introduit au Sri Lanka a un défaut dans le cas des personnes physiques bénéficiant de distributions effectuées par des sociétés résidentes: en effet la législation ne s'applique qu'aux dividendes résultant de pures distributions et ne traite pas le cas de dividendes provenant de dividendes reçus d'autres sociétés. Le Directeur général de l'Administration Fiscale a indiqué que les modifications nécessaires vont être introduites et que la situation sera en attendant rectifiée administrativement.

Ian Wallschutzsky:

International: Application des exigences de la loi dans les pays en voie de développement *234*
Il n'est pas possible d'appliquer à tous les pays en voie de développement, en raison de leurs diversités, les mêmes systèmes d'imposition. Cet article analyse les différents aspects d'un système d'impôt sur le revenu quant aux exigences de la loi auxquelles sont soumis les contribuables et qui peuvent, dans une certaine mesure, être contrôlées aussi bien par les législateurs que par les fonctionnaires de l'administration fiscale.

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Rosemarie Sanderson Schadé:

USA: Vorrang nationaler Gesetzgebung gegenüber Doppelbesteuerungsabkommen und das „Technical and Miscellaneous Revenue Act of 1988" *214*
Die „TAMRA"-Gesetzgebung kodifiziert das „später in der Zeit"-Prinzip, welches bestimmt, dass die amerikanischen Doppelbesteuerungsabkommen und die nationalen Steuergesetze gleichrangig sind. Im Falle eines Konfliktes zwischen den Bestimmungen eines DBAs und eines Gesetzes wird das Abkommen oder das Gesetz, das als letztes verabschiedet wurde, den Vorrang haben, ohne dass man zu beweisen braucht, dass das Parlament beabsichtigte, die Gesetzesbestimmungen gegenüber den DBAs Vorrang zu geben. Die „TAMRA"-Gesetzgebung zählt auch die Bestimmungen des „Tax Reform Act" 1986 auf, welche den Vorrang haben gegenüber widersprüchlichen DBA-Bestimmungen, wie auch die bestehenden DBA-Bestimmungen, welche Vorrang geniessen gegenüber dem Gesetz von 1986. Zum Schluss ändert die „TAMRA"-Gesetzgebung eine Anzahl von Bestimmungen des „Internal Revenue Code", die für Steuerpflichtige, welche die DBA-Bestimmungen benutzen, zutreffend sind, und führt neue Erklärungsverpflichtungen für sie ein. Dieser Artikel beschreibt die Hintergründe, die zu der Verabschiedung der „TAMRA"-Gesetzgebung geführt haben und analysiert die Änderungen, die von ihr eingeführt wurden.

Arthur Young International:

Die Einkommensteuer in Kanada *218*
Dieser Artikel beschreibt die relevanten Einzelheiten der Einkommensbesteuerung von ausländischen Arbeitnehmern in Kanada, besonders für amerikanische Staatsangehörige.

Veranstaltungskalender *222*

William Cunningham:

Portugal: Die Quellensteuern *223*
Mit dem Ziel, die Steuervermeidung und die Abwälzung der administrativen Bürde auf die Steuerpflichtigen zu bekämpfen, konzentriert sich das portugiesische Steuersystem nach der Steuerreform 1989 viel mehr als vorher auf die Steuererhebung durch Quellenabzug. Dieser Artikel beschreibt die Einkunftsarten, welche der portugiesischen Quellensteuer unterliegen, und gibt eine Aufzählung der Umstände, die für die Abzugsbestimmungen von Bedeutung sind.

Luis Guillermo Morales:

Kolumbien: Die Besteuerung von Einkünften aus Gewerbebetrieb und Kapitalvermögen: Ein Überblick der Zielsetzungen und der alternativen Lösungen *225*
Ein aus internationalen Steuersachverständigen bestehender Ausschuss verfasste einen Bericht mit dem Titel „Die Besteuerung von Einkünften aus Gewerbebetrieb und Kapitalvermögen in Kolumbien". Der Zweck dieses Berichtes ist, die kolumbianische Regierung bei ihrem Versuch, zu entscheiden, ob und wie sie die inflationskorrigierenden Bestimmungen der Steuerreformgesetzgebung 1986 ändern soll, zu beraten. Der Bericht beschreibt zwei alternative Lösungen: die Beibehaltung einer Einkommensteuer, welche die Inflation berücksichtigt oder die Einführung eines Systems von direkten Steuern, die mehr den Verbrauch als das Einkommen als Bemessungsgrundlage haben (vereinfachte alternative Steuer). Dieser Artikel bietet einen Überblick des ersten Kapitels des Berichtes, beschreibt die politischen Zielsetzungen eines Steuersystems und evaluiert die Vorteile der beiden Alternativen, die im Bericht präsentiert wurden.

Sri Lanka: Änderung des Anrechnungsverfahrens *232*
Das vor kurzem in Sri Lanka eingeführte Anrechnungsverfahren zeigt einen Mangel bezüglich bestimmter kwalifizierter Dividendenausschüttungen, die von unbeschränkt steuerpflichtigen Körperschaften an natürliche Personen geleistet werden. Dies bedeutet, dass das Gesetz nur Dividenden in Betracht nimmt, welche als kwalifizierte Ausschüttungen betrachtet werden, und über Dividenden, die eine Körperschaft von einer anderen empfängt und weiter ausschüttet, schweigt. Der Steuerdirektor machte kürzlich bekannt, dass man die notwendigen Änderungen im Gesetz vornehmen werde und dass inzwischen administrative Massnahmen getroffen werden, um die Situation zu berichtigen.

Ian Wallschutzsky:

International: Wie man in Entwicklungsländern die Steuerzahler Ihren Verpflichtungen nachkommen lässt *234*
Die Gestaltung der Steuersysteme der Entwicklungsländer ist sehr verschieden. Dieser Artikel untersucht verschiedene Aspekte eines Systems von Einkommensbesteuerung, welche die Art, in der Steuerzahler ihren Verpflichtungen nachkommen werden, beeinflussen und über welche die Gesetzgeber und Steuerbehörden bis zu einem gewissen Grade Kontrolle ausüben können.

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Dividend Imputation: The New Zealand Model

D.J. Hasseldine

Mr. Hasseldine is the *Bulletin* correspondent for New Zealand. He is a full-time lecturer in Accountancy at the University of Canterbury and is the author of numerous articles.

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I. INTRODUCTION

The dividend imputation system recently introduced in New Zealand is the latest measure in a series of reforms enacted this century covering the taxation of dividends received by individuals. Briefly these changes were as follows:

Between 1892 (when income tax was first charged in New Zealand) and 1930 dividends paid by companies were largely exempt from taxation. From 1931 dividends were included in "non-assessable income", a concept then used for rate determination purposes. In 1958 dividends became normal assessable income for individuals (but not for companies), taxed up to a maximum rate of 35%. This ensured that corporate and personal tax in total could not exceed the then maximum personal rate of 68%.

Between 1958 and 1985 companies were able to distribute non-taxable capital profits, which were then non-taxable in the recipient's hands, although the precise rules varied. Latterly the most common source of capital distributions were from realized capital profits and from revaluation reserves. Bonus issue tax was imposed from 1967 to 1982 on the company declaring the issue, from specified sources, at the flat rate of 17.5%. On its abolition, bonus issues were only taxed if there was a return of capital within 10 years of the bonus issue. Since 1979, the first $ 200 of combined interest and dividends received by individuals has been exempt from taxation.

Dividend reinvestment schemes were first introduced in 1983 to New Zealand and continued to proliferate after 1985 legislation removed possibilities for tax-free cash distributions. In these schemes shareholders can elect to participate in a plan where they receive fully paid bonus shares in lieu of dividends. These are issued at a small discount, from the strike price, usually 5 or 10%, which is typically an average of market prices over a few days prior to the ex-dividend date. These shares were not taxable until 1 October 1988, and this was a major reason for their popularity.

The New Zealand Government first announced its intention to introduce a dividend imputation system on 20 August 1985 in a Statement on Taxation and Benefit Reform. The proposal was confirmed on 17 December 1987 by the release of a Consultative Document on Full Imputation which outlined the proposed system and called for public submissions to a Consultative Committee comprised of leading tax specialists. Two Reports on imputation have been released by the committee together with draft legislation. Virtually all of their recommendations were accepted by the Government and these have now been passed into law under the Income Tax Amendment Act (No. 5) 1988. This Act inserted the imputation provisions into a new Part XIIA of the Income Tax Act 1976[1] immediately after Part XII dealing with the provisional tax system.

This article is split into 7 sections. The full imputation system as outlined in the Consultative Documents, Reports and subsequent legislation is described in section 2. Sections 3 and 4 respectively discuss the dividend withholding payment provisions and the interaction of this and full imputation with the branch-equivalent method of the new international tax regime. In section 5, a number of ancillary taxation matters arising from these reforms are outlined. In section 6, the implications resulting from the introduction of imputation to New Zealand are considered. Some concluding remarks are then made in section 7.

1. All section references in this article are to the New Zealand Income Tax Act 1976.

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II. FULL IMPUTATION

Imputation was designed by the Government to achieve 2 objectives:

> "1. – to ensure that, as far as possible, income earned through a company is taxed at the marginal tax rates of the shareholders of the company in accordance with the economic objective of taxing capital income [i.e. the return on capital] at the tax rates of the owners of the capital; and
> 2. – to minimize the additional administrative and compliance costs of the new provisions."

Apart from an imputation system a number of other options were available to reduce the ills of the classical method of taxing companies and their shareholders. These were the full integration, dividend deduction, split-rate and dividend exemption systems. Although full integration might have been the preferred option in theory, the Government's decision in February 1988 not to move to a flat personal income tax rate made this option more difficult.[2] The Committee concluded that a full imputation system would also be preferable to a dividend exemption system given the possible adoption of some form of capital gains taxation in the near future.

An imputation system achieves the first objective listed above by requiring resident shareholders to gross up the distribution of company income by the company tax allocated, thereby being assessable on the grossed up amount but also receiving an imputed tax credit for the amount of company tax allocated. Any unused portion of the credit is available to offset shareholders' other tax liabilities.

A. Overview of system

The main features of the imputation system are:

- Imputation credits are only given for the New Zealand company tax paid in respect of 1989 and subsequent income years. Credits are not given for foreign tax paid by the company, even if there is a double tax agreement with the country.[3]
- The method for recording and limiting the credits to be allocated is by an account-based approach (the Imputation Credit Account) rather than a compensatory tax approach such as the United Kingdom system.
- Dividends paid out of income which does not bear New Zealand company tax (e.g. capital and revaluation gains) will remain assessable to the shareholder recipients, thus ensuring that tax preferences will not be passed on (i.e. no imputation credits can be allocated in this situation). Even if, in principle, preferences should flow through, the Committee believed that this would result in additional pressure on the corporate tax base, arising from the exemption of certain dividends, thus putting pressure to convert company income into the preferred form.
- Imputation credits can only be set off against a tax liability by New Zealand residents.
- The ultimate beneficiaries of the imputation system are individual shareholders. Dividends received by companies remain exempt, although any imputation credits attached pass through its imputation credit account. Companies will of course bear a substantial administrative impact from the scheme.

These features are illustrated in Table 1 with more specific features being discussed in later subsections.

TABLE 1
How imputation operates in New Zealand

Company	A	B
Company profit	$ 1,000	$ 1,000
New Zealand company tax paid	280	0
Profits distributed	720	1,000
Shareholder level		
Cash dividend received	720	1,000
Imputation credit	280	—
Taxable dividend	1,000	1,000
Income tax (24%)	240	240
Imputation credit	280	—
Tax payable	(40)	240

1. Company A paid tax at the normal company rate but Company B declared profits comprised of non-taxable capital and revaluation gains. The example assumes all profits were distributed.
2. In the case that a shareholder was on the top marginal tax rate of 33%, the excess imputation credit of $ 40 from Company A would change to a net tax liability of $ 50 (i.e. $ 330 - $ 280).
3. The excess credit of $ 40 is not refundable but can be converted into a carry-forward tax loss.

B. The imputation credit account

Resident companies are required to maintain a memorandum record, the Imputation Credit Account (ICA), to ensure that accurate records are kept of the credits a company can build up and allocate. The ICA is central to the imputation system and there are strict rules as to its operation. As it is a memorandum account only, it will not fall within the formal double entry accounting system, though it may ultimately become part of the financial reporting system.

Companies non-resident in New Zealand, or those exempt from tax or engaged solely in the business of life insurance or reinsurance, are among those companies that cannot establish and operate an ICA.

Credits to the ICA can arise from the following sources (Sec. 394-D):

2. The Government in December 1987 had proposed to introduce a flat rate personal tax.
3. This was a change from the Consultative Document which proposed that dividend withholding taxes levied by countries with which New Zealand has a double tax agreement on dividends received by a resident company should be credited to the ICA of the recipient company. This change was instituted by the Minister of Finance since the international tax regime adopted was somewhat less comprehensive than first proposed, and because of the possibility of this leading to a significant tax influence on the decision by firms about whether to hold foreign-sourced debt or equity instruments.

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- Payments of New Zealand company income tax (being provisional and terminal taxes) for 1989 and all subsequent years. The amount of the credit will exactly equal the amount of the tax paid.
- The receipt by a company of an imputation credit in respect of a dividend (or bonus share) from another resident company.

Credits can also arise in respect of withholding payments made and branch equivalent tax paid (these are both examined in sections 3 and 4). Credits are not permitted in respect of fringe benefit tax, land tax, goods and services tax (GST) or any penalty taxes.

Debits to the ICA can arise as follows (Sec. 394-E):[4]

- Any refund of New Zealand company tax for 1989 and all subsequent years.
- The allocation of imputation credits to shareholders with dividend payments. The credit is attached to the dividend under Sec. 394-F.

The dates on which credits and debts can be made are respectively the dates on which tax payments are posted by the company or on which dividends are received, the dates on which dividends are paid (not declared) or the date of receipt of an income tax refund.

Refunds of tax to a New Zeland resident company are limited to the credit balance, if any, in the ICA at the preceding 31 March, with any excess not refunded by the Inland Revenue Department being offset against a future income tax liability. If this were not the case, then a tax refund would cause an immediate debit balance in the ICA which would then have to be cleared either during the year or at the annual account balance (Sec. 394-M).

Annual account balance

In the Consultative Document it was proposed that the balance in the ICA be prohibited to fall below zero at any time, but this was considered unworkable.[5] More importantly, on an annual basis, credits allocated should not exceed credits available. The ICA can therefore go into debit during the course of the tax year as long as it is cleared by 31 March. The balance date for the ICA (and any other memorandum accounts – see sections 3 and 4) will be 31 March irrespective of the company's accounting year end.

Where the ICA is in debit at 31 March, a further income tax payment must be made by 31 May to clear the debit balance (Sec. 394-L). In addition, a 10% imputation penalty tax is also payable on the debit by 31 May with further penalties applying for late payment of either income tax or penalty tax (Sec. 394-N). These penalties cannot be credited to the ICA. Finally the Commissioner of the Inland Revenue Department has recourse to the shareholders for any over-allocated credits not made good by a company. It was noted that these measures could be strengthened if it became apparent that companies were either deliberately or carelessly over-allocating tax credits.

In the case of credit balances at 31 March, these may be carried forward providing a 75% continuity of shareholder interests test is met by companies. The test refers to Sec. 191 which deals with the "prescribed proportions" held by individual shareholders in group companies. For the purposes of imputation, this is simplified to "the rights of any person to receive profits that may be distributed", i.e. there are no references to the proportion of paid up capital, allotted shares or voting power.

There are no grouping provisions for debit and credit ICA balances existing within a company group to be automatically offset against each other although this can of course be effectively achieved, to a greater or lesser degree, by the careful planning of intra-group dividends.

Table 2 presents a sample ICA.

TABLE 2
A sample imputation credit account

Debits		*Credits*	
22/8/88 Allocation (Net dividend $ 7,200 – ratio is 28/72)	$ 2,800	7/11/88 Provisional tax paid	$ 1,500
		31/1/89 Credit allocated on dividend received from ABC Limited	1,000
		31/3/89 Debit balance carried down	300
	$ 2,800		$ 2,800
1/4/89 Debit balance brought down	300	31/5/89 Additional tax payment	300

1. The 10% penalty of $30 must also be paid by 31 May 1989 but cannot be credited to the ICA.
2. If a tax refund was due in respect of the 1989 tax year, the debit balance will preclude it from being refunded and it would be offset against a future provisional tax instalment.

C. Compliance rules

Returns

In order to monitor the imputation system, an annual imputation return must be filed with the Inland Revenue Department by 31 May each year (Sec. 394-J). Details required include:

- opening and closing balances of the ICA for the year,
- amount and source of all credits and debits,
- further tax payable due to a debit balance,
- any imputation penalty tax payable,
- any further information required by the Commissioner.

A company also has an obligation to disclose in its return where either of the following ratios have in-

4. Debits may also arise in certain other situations. These are listed in Section 394-E and include ceasing to become a New Zealand resident (or company permitted to operate an ICA), failing the 75% shareholder continuity test, receiving a refund of excess retention tax, infringing either the 31 March debit balance provision or the allocation rules, and a specific case in relation to the international tax regime.
5. This would have ensured that the timing of dividend payments would be strictly influenced by the due date of the various tax instalments.

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creased or decreased by more than 20% over the prior imputation year:

Ratio 1

$$\frac{\text{imputation + withholding payment credits attached}}{\text{total amount of all dividends paid in year}}$$

Ratio 1 is therefore a distribution ratio.

Ratio 2

$$\frac{\text{total debits to ICA during year}}{\text{total credits to ICA during year}}$$

Ratio 2 is an account movement ratio reflecting the change in status of the account. As debits should not exceed credits, the ratio should generally be less than or equal to 1.0, unless a credit balance brought forward from a prior year is reduced during the year.

If either ratio has varied by 20% or more, an explanation of the change must be furnished.

In the case of a company ceasing to be an ICA company (for example on the relinquishment of New Zealand resident status), its return must be furnished within 2 months of it ceasing to be an ICA company (Sec. 394-K).

Statements

In addition, companies are required to make a company dividend statement (Sec. 394-H) and to issue a shareholder dividend statement (Sec. 394-I) to shareholders at the time of any credit allocation. The company dividend statement is in essence a formality similar to a directors' resolution to pay a dividend, probably also being recorded in the minute book since it must be made at the time of the declaration of a dividend. This statement must be furnished to the Commissioner by 31 May following each imputation year.

The company dividend statement includes:

- the number of shares to which the allocation relates,
- dates of directors' resolution and dividend payment,
- total dividend paid or amount capitalized (for bonus issues),
- total imputation credits attached and the credits/dividends paid ratio.

The shareholder dividend statement includes:

- company name and payment date,
- name and address of shareholder,
- net dividend paid (excluding credit),
- amount of imputation credit,
- gross dividend,
- any non-resident withholding tax deducted.

Shareholder dividend statements are particularly important for individual shareholders as they (or other sufficient evidence) must be supplied to the Commissioner before a credit of tax is allowed in their individual tax assessments.

D. Allocation rules for imputation credits (Sec. 394-G)

There is no statutory obligation on a company to allocate any credit to a dividend, but if it does make an allocation, then various rules apply. Under imputation, all of a firm's shareholders have in effect been deemed to have borne the company tax allocated. As a general principle (from the point of protecting the Revenue), credits should be distributed to shareholders on a pro rata basis. Consequently provisions have been designed to prevent companies from directing or "streaming" tax credits to those who can most effectively use them while possibly providing some other benefit to shareholders who cannot.

The consultative Document proposed 2 anti-streaming provisions:

(1) that for all classes of shares, the ratio of the aggregate credit per share to the aggregate taxable value of distributions per share must be the same in a particular income year, and
(2) that for any class of share, the credit per share must be the same for all shares of that class on the day credits are allocated.

However, this was thought to involve some difficulty in satisfactorily defining a class of share. Instead the committee suggested alternative rules:

1. The maximum "imputation ratio" (the ratio of the imputation credit to the net dividend) would be:

$$\frac{\text{company tax rate}}{1 - \text{company tax rate}}$$

From the 1989 tax year with corporate tax at a flat rate of 28%, the ratio is 28 divided by 72 = 0.388. If a company exceeds this ratio, then as a penalty measure the excess credit is not allowed to shareholders or included in the definition of a dividend (i.e. the excess is wasted).

2. The imputation ratio for all dividends paid in any income year is the same as that applying to the first dividend, i.e. a benchmark will be set. A company is permitted to alter its "benchmark" imputation ratio provided a ratio change declaration is furnished to the Inland Revenue Department by the company prior to the dividend being paid; the main element of this declaration being that the change did not convey an imputation credit benefit to one group of shareholders vis-à-vis another.

3. If the imputation ratios of subsequent distributions do not conform to the benchmark and no declaration is filed, then all dividends will be deemed to have an imputation ratio equal to the highest one applied by the company during that year. The difference between the actual allocation of debits and the deemed allocation is debited to the ICA as an allocation debit (Sec. 394-G(4)). This represents tax paid for which credits are effectively lost and/or additonal tax liability for the company. Then if the account is in debit at 31 March, the penalty rules previously outlined will apply.

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It is important to note that the allocation rules apply across all dividends paid in any year. Therefore credits allocated to differing classes of shares, e.g. preference shares, must comply with any benchmark, unless the necessary ratio change declaration is furnished.

Any distribution a shareholder receives by virtue of an interest in a company is deemed for the purposes of the allocation rules to be a dividend paid by that company.

The effect of the allocation rules just outlined could be avoided by the accumulation of credits in companies which were then sold and the credits then utilized by new shareholders. It was for this reason that the 75% continuity of shareholding test was introduced. The compliance costs of this test would be greatest for publicly listed companies due to normal trading and interposed holdings, so an exception to the rule applies to companies listed on the New Zealand stock exchange and their fully owned subsidiaries.

E. Bonus issues

To recognize the similarity between share splits and bonus issues as well as to permit companies to allocate imputation credits to shareholders without the need to pay dividends, the committee recommended that an option be available. From 1 October 1988 companies can, under Sec. 4(5), elect to declare bonus issues which are either:

(a) taxable to shareholders to which imputation credits may be allocated; or
(b) non-taxable to shareholders.

Any bonus shares offered in lieu of dividends will be treated as taxable, i.e. (a) will apply and imputation credits can be attached. This provision applies to issues where the shareholder elects to receive shares under a dividend reinvestment scheme. As an associated measure, non-resident withholding tax is payable in respect of taxable bonus shares issued to non-residents after 1 October 1988 (Sec. 313).

If the company fails to make an election on whether the bonus issue is taxable or not, it will be deemed to be a non-taxable bonus issue – to which no credits may be attached.

Taxable bonus issues are subject to the same allocation rules as cash dividends and will result in an increase of paid-up capital for tax purposes. Non-taxable issues are not capitalized for tax purposes but retain their pre-capitalization status, i.e. revenue or capital reserves. Obviously for company law and reporting purposes they will be capital. This has an impact in the following areas:

1. First, in a reduction of capital and on winding up there will be different taxation implications between equity for tax purposes and for company law purposes. For example, taxable bonus issues will be tax-free on winding up whereas non-taxable bonus issues will not.

2. The issue arises "Can imputation credits be given on dividends subsequently paid on those bonus shares that are not even recognized for taxation purposes?" This is possible as full details of the dividends and bonus issues made must be furnished to the Inland Revenue Department as described earlier. The divergence between the equity balances in the 2 balance sheets may grow quite large.

The possibility of a future tax liability as a result of tax-free bonus issues made may lead to pricing implications in the equity market although this does not seem to be widely recognized as yet. As the legislation is new, there have been no documented instances yet of companies making tax-free bonus issues under imputation.

F. Unutilized credits and tax losses

As a matter of policy the Government decided that an individual shareholder's unutilized imputation credits would not be refundable so that the status quo for non-resident and tax-exempt shareholders would be preserved. A system for carrying forward unutilized credits would have been desirable but that was unable to be immediately implemented into the Inland Revenue Department's existing EDP system.

The solution adopted is for all resident taxpayers (apart from companies) to be able to convert any imputation credits in excess of their tax liability, in any year, into a tax loss to be carried forward, with the amount equal to the unutilized tax credits divided by the company tax rate – 28%. Similarly any non-company taxpayer already in tax loss will just increase the loss in the same manner (Sec. 394-ZE).

G. Anti-avoidance provisions

The imputation legislation has its own specific anti-avoidance provisions (Secs. 394-ZF and 394-ZG). These are intended to counteract any artificial attempts to circumvent the imputation rules to obtain a "taxation advantage".

They apply both to companies and individuals and if the Commissioner determines that an "arrangement to obtain a taxation advantage" exists, various reconstruction powers can be used, e.g. not allowing a credit to an individual shareholder.

Sec. 99 – the main avoidance provision of the Income Tax Act – will still apply even though the imputation rules contain specific anti-avoidance provisions. This principle has applied since the 1986 Privy Council judgement in *Commissioner of Inland Revenue vs. Challenge Corporation Ltd.*[6]

In the case of technical errors leading to incorrect entries in the memorandum accounts, either in amount or timing, then the Commissioner may determine the correct entries to be made and give notice of determi-

6. (1986) 8 *New Zealand Tax Cases* at 5219. This case has led to a new direction in the interpretation of anti-avoidance legislation, e.g. the Privy Council expressly rejected the concept known as the "doctrine of choice".

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nation to the taxpayer. The Commissioner's determination may be objected to in accordance with the usual objection procedures, i.e. in writing, within time and stating the grounds for objection.

III. FOREIGN DIVIDEND WITHHOLDING PAYMENT REGIME

A withholding payment system, contained in Part XIIB of the Income Tax Act, has been introduced that applies to all foreign-sourced dividends received after 1 April 1988 by New Zealand resident companies. These dividends are those received from non-resident companies and companies resident in New Zealand but treated as non-resident pursuant to a double tax agreement (Sec. 394-ZL).

It involves a withholding payment (set at the company tax rate of 28%) to be paid to the Inland Revenue Department by the 14th of the month after each quarter. The net payment to be made takes into account any foreign withholding tax imposed on the dividend.

Companies are still exempt from income tax on these dividends but the rationale is that the payment will approximate the income tax that would be payable in a dividend from a non-resident company directly to a New Zealand individual shareholder. The net payment can be allocated to dividends or bonus issues made in a similar way to imputation credits. Companies at their option may account for these payments and allocations through the ICA, in which case no differentiation of the type of credit is made. Alternatively, in the case of companies with more significant interests in non-resident companies, a Withholding Payment Account (WPA) can be established (Sec. 394-ZT).

The WPA, also being a memorandum account, operates in a similar fashion to the ICA, but with some differences:

1. Credits arise from withholding payments made to the Revenue and credits received from other companies (Sec. 394-ZV), with debits arising from allocations to shareholders (Sec. 394-ZW).

2. The WPA will be balanced at 31 March and an annual dividend withholding payment account return, showing details similar to the ICA return, must be furnished by 31 May (Sec. 394-ZZC). Debit balances again must be cleared, with penalty, by 31 May with shareholders not receiving credit for any deemed debits on balance date. Compounding penalties apply in the case of late payment. Credit balances can also be carried forward subject to the 75% common shareholding test being met. A credit balance in the WPA is available for transfer to balance the ICA, but not vice versa. This follows because withholding payment credits are refundable, whereas unutilized imputation credits are not. Curiously enough, an election to transfer is made by the completion of the journal entry (Sec. 394-ZZE).

3. Similar allocation rules apply (e.g. the benchmark and ratio change declarations provisions), except in this case the equivalent of the imputation ratio is the "dividend withholding payment ratio", with the same maximum, currently of 28 divided by 72 (Sec. 394-ZY). If both imputation and withholding payment credits are allocated to a distribution, the aggregate credit ratio cannot exceed the tax rate divided by the complement of that rate (Sec. 394-ZZ).

4. On the allocation of withholding payment credits, a company dividend statement must be completed and shareholder dividend statements must be given to the shareholders with additional details including the amount of withholding payment credits attached to the dividend. Shareholders will then gross up their dividends and then receive a credit of tax in their tax assessments in exactly the same manner as for imputation credits.

A company in tax loss with a withholding payment liability has the option of electing to offset its liability by reducing its tax loss, as far as the loss extends, by the liability divided by the company tax rate (Sec. 394-ZN). This option is in lieu of making payment of the withholding tax and no WPA credit will arise in this situation. The election may be disallowed if in fact there is no loss established to the Revenue's satisfaction. In this case, liability will be restored together with penalty.

Refunds of dividend withholding payments (Sec. 394-ZQ)

Where the eventual recipient shareholder would not incur a tax liability on the distribution, the withholding payment is to be refunded. Refunds to non-residents, tax-exempt shareholders and shareholders for whom the amount withheld exceeds their tax liability (Sec. 394-ZP) are made on an annual basis by the Inland Revenue Department. Refund applications must be made after 31 May following the end of the year in which the withholding payment was received and supported by the shareholder dividend statement supplied by the payer company.

In the case of non-resident individuals, the withholding payment can be viewed as an advance payment of non-resident withholding tax. Thus any withholding credit allocated on a dividend to this class of taxpayer will be credited to the non-resident withholding tax. Any shortfall must be deducted by the payee company, while any excess will be refunded on application.

Since non-resident and tax-exempt shareholders can only receive refunds in respect of withholding payment credits and an option is available to the paying company, it is conceivable that these types of taxpayers may well request the establishment of a WPA account, if none exists already. There would be no point in receiving non-refundable imputation credits when refundable withholding credits could be obtained merely by the operation of a WPA.

Figure 1 summarizes the relationships existing within the withholding payment regime. It is assumed that the New Zealand resident company is not subject to the international tax regime discussed in Section A.

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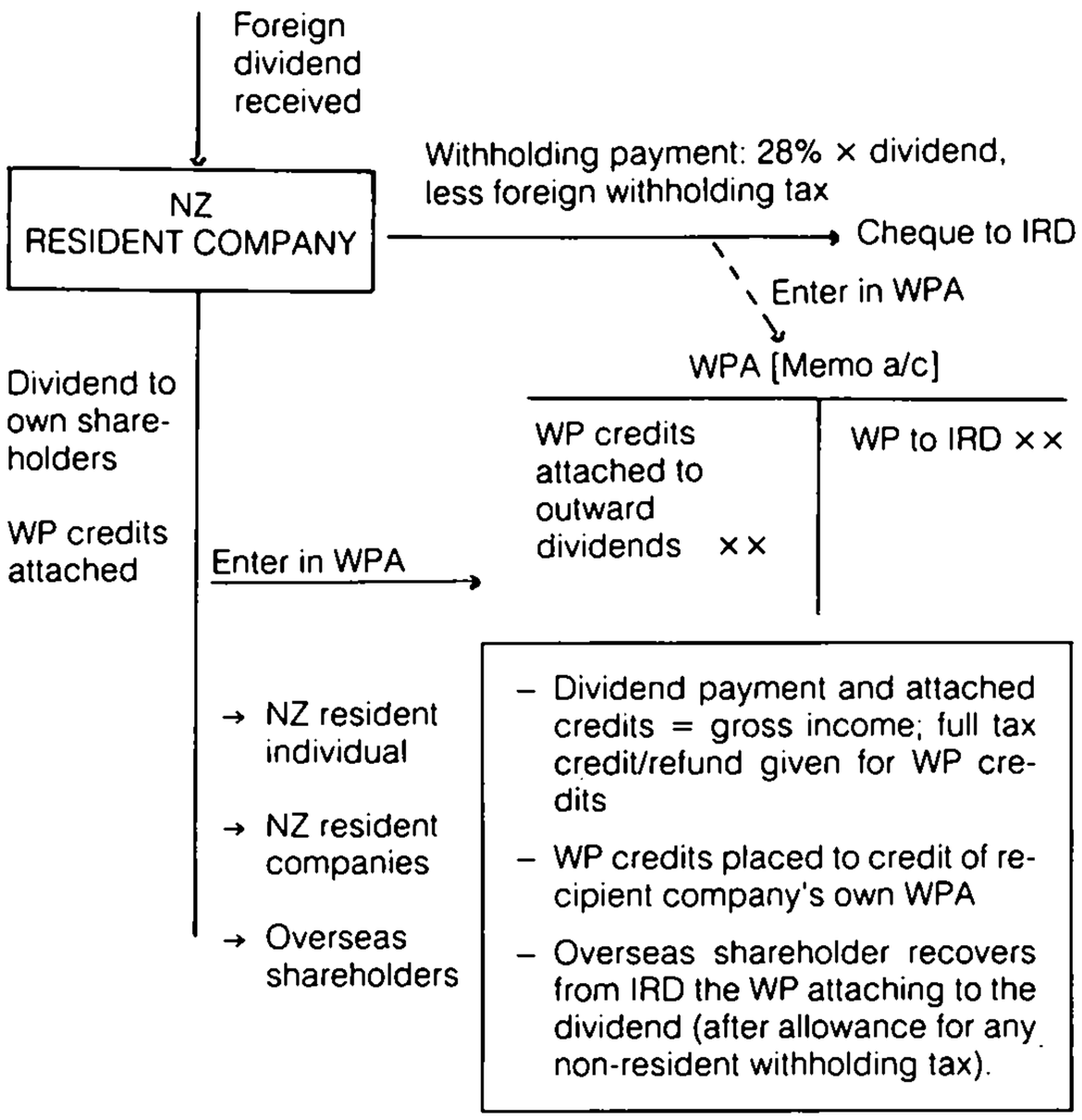
Figure 1:

The withholding payment regime



IV. INTEGRATION WITH NEW INTERNATIONAL TAX MEASURES

A Consultative Document on International Tax Reform was issued simultaneously with the document on full imputation, with submissions invited to the same Committee. This article does not examine in detail the provisions of the new international tax regime[7], but there are a number of issues that have necessarily been integrated across dividend imputation, the withholding payment regime and the international tax reforms.

With the exception of those taxpayers falling into the foreign investment fund provisions (i.e. typically where passive income is earned from foreign entities) the branch-equivalent method (BE) applies to taxpayers who hold more than a 10% "income interest" in a controlled foreign company.[8] This method requires the income of the controlled foreign company to be restated using New Zealand tax rules[9], with the income attributed to New Zealand taxpayers liable under the regime.

The interaction of this method and the imputation system is contained in Part XIIC of the Act. It provides that branch-equivalent tax paid may be accounted through the ICA and allocated as a tax credit, but the recommended practice is to elect to establish a separate sub-account of the ICA known as the branch-equivalent tax account (BETA) (Sec. 394-ZZN).

In the case of a BETA company, the opening and closing balances, together with the amounts and sources of all credits and debits, must be disclosed in the annual imputation return. The BETA is only a record-keeping account used in determining the balance of income tax paid on branch-equivalent income.

Branch-equivalent tax account entries

Credits

BE tax paid is credited to this memorandum account with a corresponding debit to the ICA (as the BETA credit represents a proportion of the taxpayer's income tax which has also been credited to the ICA (Sec. 394-ZZP)).

The BETA credit is calculated in accordance with the following formula:

$[(A + B) \times C/D] - B$

where for that year:

A = total New Zealand income tax paid by the company,
B = total foreign tax credit allowed to the company under the BE regime,
D = total New Zealand taxable income of the company,
C = lesser of BE income and D.

The above variables relate to a whole year and can only be determined at the end of the year. The BETA credit thus arises on the date of filing an annual return which should establish the values for these variables.

Debits to BETA can arise as follows:

(1) A resident company's withholding payment liability on a BE dividend (i.e. paid by a non-resident company for whose profits the resident company is assessable under the BE regime) can be offset to the extent of any credits in the company's BETA which represents tax already paid on the same income. The offset will give rise to a debit to BETA and a credit to the ICA to be entered on the date at which the withholding payment would otherwise be due. If a BETA was not established, any BE dividends would be subject to the Withholding Payment Regime in the same way as for non-BE dividends and double taxation would result. New Zealand companies in this situation will ideally want control over the timing of dividends from the foreign source or at least exert some influence over them.

(2) BETA credits can also be allocated by a company to its shareholders, but these must first be transferred through the ICA (i.e. debit BETA, credit ICA) and will be limited to the credit in the BETA. This is to

7. The provisions of the regime are quite complex and as a first step it is suggested that interested readers consult Turner, "International Tax Reform", *New Zealand Accountants' Journal*, Vol. 67 No. 5 (June 1988) at 22.
8. The test of control is satisfied if 50% of the capital, voting rights, rights to dividend income or distributions on winding up are held by 5 or fewer New Zealand residents (Sec. 245-C).
9. For the first year branch-equivalent accounts are prepared, opening balance sheet values, e.g. fixed assets, trading stock and financial arrangements will need to be determined. Income and withholding tax paid by a controlled foreign company is creditable under the branch-equivalent regime.

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avoid the complication of having 3 types of credit (ICA, WPA and BETA) all subject to the same allocation rules and recognizes that the BETA is only a sub-account of the ICA. A transfer in the reverse direction is not permissible as it is not consistent with the purpose of BETA (to allow a withholding payment liability to be offset to avoid double taxation). Thus once BETA credits are transferred to the ICA, they can no longer be used to offset a withholding payment liability.

(3) If BE tax has been overpaid and BETA credits have been offset against a withholding payment liability, this results in a withholding payment shortfall. Rather than permit amended accounting entries to be made, the Committee opted for BE tax refunds to be made by the Inland Revenue Department, being limited to the credit balance in the BETA. Any amount in excess of this is not refunded or carried forward as this represents the withholding payment previously underpaid.

Individuals who are subject to the BE regime may set up an individual BETA with a similar calculation process applying except that the credits will offset not withholding payment liability but income tax liability. Such taxpayers will have to file details of their BETA with their annual tax return.

The Appendix is an annex extracted for the Consultative Committee's Report (Part 1) which illustrates the interaction of the ICA, BETA and WPA.

V. OTHER ANCILLARY MATTERS

A. Partnerships

In New Zealand partnerships have no separate tax status from that of the individual partners. Accordingly dividends, bonus shares and imputation credits are allocated to partners in proportion to their income interests in partnership income (Sec. 394-ZD(4)).

B. Residence and changes thereof

Pursuant to the Income Tax Act 1976, company residence was determined by either incorporation or a "head office" within New Zealand. Head office was defined as the "centre of administrative management". Due to interpretation problems and to make it easier to become a resident and more difficult to achieve non-resident status, an amendment was passed strengthening both individual and company residence tests with general effect from 1 April 1989. Company residence now also includes a test on the centre of director control. This means residence will no longer be avoided by the holding of one or more directors' meetings outside the country.

The imputation scheme applies only to companies which are resident in New Zealand. Hence, non-resident companies are unable to establish an ICA to distribute credits to New Zealand shareholders even if their income includes New Zealand-sourced income on which tax has been paid. This may seem harsh from the point of view of imputation, but the Consultative Committee felt that international tax issues made this necessary.[10]

When a company becomes a resident, it is required to establish an ICA (with the option also of a WPA and BETA), with all accounts having an opening zero balance. So that the Withholding Payment Regime is not avoided by becoming resident, the amount of taxable reserves must be quantified and all future distributions treated as coming from these reserves until they are exhausted. Corporate recipients of any such distributions must treat them as Withholding Payments. Companies in this situation are effectively dual resident, i.e. in respect of future income earned they will be classed as a New Zealand resident, while being given non-resident status in respect of their pre-residence reserves.

In the case of a company ceasing to be resident, credit balances in the ICA and WPA are extinguished (via a debit entry) and debit balances must be paid to the Inland Revenue Department.

C. Capital gains tax and further reform

Under current New Zealand law, companies are prevented from buying their own shares.[11] If this restriction were removed, as has been proposed, companies could distribute retained earnings by share repurchase. For this reason (although there are many others), the Committee endorsed the Government's decision to give priority to the investigation of a system of taxing capital gains. To date, no firm proposals or consultative documents have been published by Government, although the topic is of course being discussed in the New Zealand literature.

As part of its report the Committee also urged the introduction of inter-jurisdictional allocation rules that would cover expenses allocation, transfer pricing and thin capitalization.

D. Excess retention tax

This is a tax couched in the Income Tax Act 1976 whose function is to encourage closely held companies to distribute their profits. It does this by imposing a tax, to be decreased to 33% from the year of assessment commencing 1 April 1991, on the undistributed income of privately controlled investment companies, which are proprietary companies[12] engaged exclusively or principally in investment activities.

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10. There have been media reports, especially of Trans-Tasman companies, who are disgruntled that they cannot pass on imputation credits to significant numbers of shareholders in either New Zealand or Australia. For example, the Chairman of the ANZ Banking Group indicated that lobbying is continuing in an effort to change this situation. Reported in *The Christchurch Press*, 2 February 1989.
11. Sec. 62 of the Companies Act 1955.
12. A proprietary company is one which at the end of its accounting year is under the control of 4 or fewer persons.

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Part 1 of the Consultative Committee's report recommended that this tax be abolished, but in Part 2 (published subsequently), a change of heart led to the retention and strengthening of this tax. Excess retention tax must still be taken seriously by privately controlled investment companies.

E. Dividend withholding tax

New Zealand is currently in the process of introducing a dividend withholding tax (DWT) in an effort to combat tax evasion, although the details have not yet been finalized. Key aspects at this stage are:

- DWT at 28% will be charged on dividends which have no imputation credits attached. The situation where imputation credits are less than the maximum rate is at present unclear.
- DWT will be an interim tax available for credit in shareholders' assessment.
- Taxable bonus issues will be subject to DWT.
- Dividends to companies and non-residents will not be liable.
- DWT will apply to dividends to shareholder employees.

This was scheduled to apply from 1 April 1989 but seems likely to be delayed. This measure is similar to the intended domestic interest withholding tax regime canvassed in New Zealand in another attempt to combat tax evasion. This was originally scheduled to operate from mid-1989, but has now been postponed. The implications of DWT are naturally still uncertain, but the definition of "dividend", the criteria for filing a tax return and the existing $ 200 interest and dividend exemption are all areas likely to be amended.

VI. THE IMPLICATIONS OF IMPUTATION

A. Dividend policy

Generally it is expected that investors will welcome imputation[13] as may companies with the ability to allocate imputation credits. The DWT provisions should make these firms even more attractive to investors. Conceivably, some impounding effect on share prices may have already taken place. Investors may prefer to receive their dividends just prior to the due dates for payment of provisional tax, although there has been no public pressure exerted to date for this to occur. Planning for imputation is very important and dividend policy is a key tool which can be used not only for payouts to the public shareholding but also to actively manage all memorandum account balances within a company group. Poor management techniques in this area will no doubt lead to the payment of increased taxes – which could otherwise be avoided, or the sub-optimal timing of tax payments.

B. Dividend reinvestment schemes

As stated, the shares issued under these schemes will now be taxable to participants. In New Zealand the main stimulus for their rapid growth lay in the fact that they were not taxed whereas cash dividends were. It seems likely that other things being equal there will be a drop in participation rates, but it is important to remember that companies may use the discount from market price as an inducing effect to encourage and maintain participation.

C. Accounting disclosure

Accountants have traditionally focused on accounting for tax, i.e. income tax allocation and while the importance of this work is not in any way disputed, it is submitted that investors' primary focus will be on the tax reconciliation statement in the financial accounts. Analysts will become more interested in the likely provisional tax payable (i.e. the extent to which credits may be allocated). Any disparity between the tax and external balance sheets caused by tax-free bonus issues together with the associated pricing implications will lead to even greater pressure for accounting disclosure.[14] It is apparent that analysts will find it somewhat difficult to predict the status of the various tax accounts a company must now maintain.

Other reforms to the provisional tax regime, which impose substantial penalties for poor forecasting of actual tax results (when compared to the provisional tax paid), will lead to more effective internal planning procedures being necessary in respect of the various tax accounts.

D. Areas of further academic research

1. Share price adjustment studies

A large body of U.S. evidence indicates that share prices often do not fully adjust for cash dividends on the ex-dividend date. Barclay, in his study of share price adjustments on ex-dividends days before the federal income tax was introduced, gives credence to the hypothesis that this is caused by tax reasons. Other authors have also documented ex-day effects but in respect of share splits and bonus issues.[15] Imputation should give an ideal situation to empirically test for share price adjustments, with cash dividends and some bonus issues being taxed in the same manner. The effect of the level of imputation credit (i.e. nil up to the maximum ratio) could also be incorporated. Further, a comparison of the adjustments consequent on taxable and non-taxable bonus issues could be tested.

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13. A possible exception is the case of national superannuitants subject to a surcharge where an increase in gross dividends will bring increased surcharge in its wake.
14. The New Zealand Society of Accountants is currently considering the issue although no public pronouncements have yet been made.
15. See for example Grinblatt, et al., "The valuation effects of stock splits and stock dividends", *Journal of Financial Economics*, Vol. 13, at 461-490.

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2. Tax clienteles

Associated with the comments on accounting disclosure is the opportunity to test whether clienteles will form for companies with ability to pass on imputation credits, i.e. that pay tax and would theoretically attract individuals paying tax, and companies who cannot, in which case tax-exempt investors may be attracted.

Companies with substantial tax losses to carry forward, of which there are a number in New Zealand, will have to extinguish their losses before they are in a tax-paying position and are hence able to pass on the benefits of imputation to their shareholders. This will lead to major portfolio selection and equity pricing considerations respectively being faced by individual shareholders and the stockmarket as a whole. After all ICA credit balances can really be looked upon as a contingent asset – albeit unrecorded in the formal double entry accounting system.

3. Economic effects

A seminar on imputation held by the Institute of Policy Studies at Victoria University in February 1986 was told that New Zealand's debt/equity ratios were high by world standards and New Zealand lacked an adequate domestic equity capital base.[16] Since then, New Zealand interest rates have fallen and there have been many cases documented of companies making substantial asset sales and rationalisations in order to relieve their debt burdens, particularly where the October 1987 sharemarket crash had a major impact on balance sheet positions.

The Consultative Document itself stated that the economic costs of the classical system of taxation were largely efficiency costs. These were listed as:

- Increased costs of portfolio diversification
- Increased incentive for corporate takeover
- Increased agency costs due to non-corporate organisational forms
- Increased expected costs of financial distress and agency costs associated with higher debt levels than would exist with a more neutral tax system.

Imputation should reduce the gap in effective tax rates between equity-financed corporate investment and debt-financed and unincorporated investment. Obviously it is too early to confirm whether the efficiency costs listed above are decreasing, although the Treasury will no doubt be monitoring the contributing factors.

VII. CONCLUDING REMARKS

Dividend imputation represents a significant change to the New Zealand taxation system. The legislation is complex and far-reaching in its impact. At the company level there has been a significant change in the relationship between tax planning and dividend policy.

Further at the shareholder level there are major portfolio selection implications arising from the effect that credits have on taxable income. The system could well see more individual investors participating in the sharemarket although the memories of October 1987 still loom large in New Zealand.

The Government has now substantially removed the tax bias favouring debt over equity. It clearly hopes that the economic effects will be favourable especially in increasing the mobility of risk capital. Reductions in artificial incentives for takeovers and the influence of the tax system on other business decisions are other objectives.

New Zealand taxpayers are having to cope with several major changes in their tax system. Accountants, tax advisers and investment analysts are likely to have increasing workloads over the next year or 2 as the nation adjusts to these changes.

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APPENDIX: THE OPERATION OF THE ICA, WPA AND BETA ACCOUNTS

This annex illustrates how the ICA, WPA and BETA transactions of a company would be shown under the imputation regime. The assumptions used are outlined below. The computation of the withholding payments and imputations credits is shown in parts B and C. The subsequent pages record these transactions in the relevant accounts.

A: ASSUMPTIONS

	Income tax year		
NZ tax paid	*1989*	*1990*	*1991*
On NZ income	2,500	—	3,500
On BE income	500	1,000	700
Gross dividends received from non-residents			
BE dividend	7,000	7,500	8,000
Non-BE dividends	3,000	4,000	5,000
Dividends paid	8,000	8,500	9,000

B: WITHHOLDING PAYMENT CALCULATION

28% of BE dividend	1,960	2,100	2,240
Less foreign NRWT (say 15%)	1,050	1,125	1,200
	910	975	1,040
BETA offset	500	975	725
	410	NIL	315
28% of non-BE dividends	840	1,120	1,400
	1,250	1,120	1,715
Less foreign NRWT (say 20%)	600	800	1,000
Withholding payment payable	650	320	715

C: IMPUTATION CALCULATION

Credits a 28% × dividend paid	2,240	2,380	2,520
– from ICA	2,240	1,735	2,520
– from WPA	—	645	—

D: MEMORANDUM ACCOUNTS

BETA

1989	ICA (WP offset)	500	1989	B.E. taxes	500
1990	ICA (WP offset)	975	1990	B.E. taxes	1,000
	Balance c/d	25			
		1,000			1,000
1991	ICA (WP offset)	725	1991	Balance b/d	25
				B.E. taxes	700
		725			725

WPA

1989	Balance c/d	650	1989	W.P. paid	650
1990	Allocation	645	1990	Balance b/d	650
	Balance c/d	325		W.P. paid	320
		970			970
1991	Balance c/d	1,040	1991	Balance b/d	325
				W.P. paid	715
		1,040			1,040
			1992	Balance b/d	1,040

ICA

1989	Allocation	2,240	1989	Taxes paid	2,500
	Balance c/d	760		BETA	500
		3,000			3,000
1990	Allocation	1,735	1990	Balance b/d	760
				BETA	975
	Balance c/d	1,735			1,735
1991	Allocation	2,520	1991	Taxes paid	3,500
	Balance c/d	1,705		BETA	725
		4,225			4,225
			1992	Balance b/d	1,705

Editor's Note

Since this article was received the rate of company tax has been increased from 28% to 33% with effect from the income year commencing 1 April 1989. The maximum imputation ratio will consequently change from $^{28}/_{72}$ to $^{33}/_{67}$.

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UNITED STATES:

Tax Treaty Overrides in the Technical and Miscellaneous Revenue Act of 1988

Rosemarie Sanderson Schadé

INTRODUCTION

The Tax Reform Act of 1986[1] (the "86 Act") made far-reaching changes to the United States Internal Revenue Code (the "Code"), many of which will have a significant impact on international transactions. Several of these changes conflict with existing U.S. income tax treaties. Although questions as to the appropriate interaction between U.S. internal tax laws and U.S. income tax treaties have arisen in the past, the numerous potential treaty conflicts and inconsistencies raised by the 86 Act focused increased attention on this issue.

As a result, the Technical and Miscellaneous Revenue Act of 1988[2] ("TAMRA") addressed the problem by identifying and clarifying specific conflicts between the Code and treaties, and also by codifying a rule of law to govern the future relationship between domestic internal revenue law and tax treaty provisions. TAMRA also amends several Code provisions applying to taxpayers who utilize the benefits of tax treaties and imposes new reporting requirements on them.

This article discusses the background leading to enactment of the TAMRA provisions and analyzes the TAMRA changes.

BACKGROUND

Under the supremacy clause of the Constitution of the United States, "the Constitution and the laws of the United States which shall be made in pursuance thereof, and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land".[3] Thus, treaties which are entered into by the President with the advice and consent of the Senate, and federal legislation (including tax legislation) which is enacted by Congress, constitute the supreme law of the land and generally enjoy equal dignity.

In the event of conflict between a treaty and federal legislation, it is generally accepted that the one most recently adopted will control.[4] However, treaties obviously involve additional dimensions than domestic law: treaties are international bilateral agreements entered into between sovereign foreign nations, thus implying a measure of good faith and commitment by each participating nation which is not present in domestic legislation.[5] Consequently, under U.S. law prior to enactment of TAMRA, it was generally accepted that a treaty provision would not be overridden by subsequent domestic legislation unless Congress expressly indicated its intent to override the treaty.[6]

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Mrs. Schadé would like to thank Raul J. Salas of Shutts & Bowen, Miami, for his assistance in preparing this article.

1. Pub. L. No. 99-514 (1986).
2. Pub. L. No. 100-647 (1988).
3. U.S. Const., Art. VI, cl. 2.
4. *Reid v. Covert*, 354 U.S. 1 (1956).
5. See the Vienna Convention on the Law of Treaties, Arts. 26 and 27, requiring contracting states to observe treaty terms in good faith, meet treaty obligations as far as possible and refrain from using domestic law as grounds for non-compliance.
6. *Cook v. U.S.*, 288 U.S. 102 (1933).

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The 86 Act included several provisions in which Congress clearly indicated that existing tax treaties should be overridden. For example, Code Sec. 884(e) provides specific guidance for the interaction of tax treaties with the branch profits tax and the branch level interest tax. Congress, however, gave no indication as to the interaction of tax treaties with many other changes made in the 86 Act. As a result, some taxpayers began claiming exemptions from certain provisions of the 86 Act based on treaties in force prior to 1986. Congressional tax writers felt strongly that the policies underlying the 86 Act changes should not be undermined by existing treaty obligations, and this led to the introduction of tax treaty override legislation. As originally proposed, the treaty override legislation was quite broad and roundly criticized by tax lawyers, lobbyists and several European Governments.[7] That criticism, coupled with State Department pressure, resulted in the compromise embodied in the TAMRA provisions that are discussed below.

TAMRA CHANGES – CODE SEC. 7852

When Congress enacted the Internal Revenue Code of 1954, it included Code Sec. 7852(d) stating that no provision of the 1954 Code was to apply in any case where its application would be contrary to any treaty obligations of the United States in effect on the date of enactment (16 August 1954). The intent of Sec. 7852(d) was to ensure that the substitution of the 1954 Code for the then-existing 1939 Code did not operate to override terms of existing tax treaties.

In 1986, as part of its major reform of U.S. income tax laws, Congress substituted the Code of 1986 for the 1954 Code. During this substitution proposed amendment to Code Sec. 7852(d), providing that pre-1954 treaties were overridden by domestic law changes from 1954 through 1986, was inadvertently dropped from the 86 Act.[8] Thus, under the 86 Act and prior to passage of TAMRA, Sec. 7852(d) literally meant that no provision of the 1986 Code would apply in any case where application was contrary to any treaty obligation of the United States in effect on the date of enactment (22 October 1986). The TAMRA legislation[9] turned this rule around 180 degrees.

TAMRA enacts 2 rules governing the relationship between tax treaties and the Code. First, under Code Sec. 7852(d)(2) now entitled "Savings Clause for 1954 Treaties", no provision of the original 1954 Code will apply in any case where application would be contrary to any treaty in effect on its date of enactment (16 August 1954). This essentially returns the law to where it was before the 86 Act. Thus, treaty provisions which were in effect in 1954 and which conflicted with the Code of 1954 (as originally enacted) will prevail over the original provisions of the 1954 Code, but not over later amendments, such as those made by the 86 Act.

Second, Code Sec. 7852(d)(1) codifies a general rule of law that the treaty or statute enacted "later in time" will prevail. Specifically, the section states that "for purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." The Congressional Conference Committee report explains this rule to mean that where the relationship of a treaty and a statute must be determined, the treaty should be accorded the regard due to it under ordinary rules of interpreting laws of equal dignity.[10] Based upon prior case law, then, treaty provisions and domestic law provisions are to be construed harmoniously if possible; if that is not possible, then the law adopted later in time will prevail.[11]

For example, if application of a treaty term results in certain tax treatment with respect to a particular item of income (i.e. an exemption or reduction of U.S. tax on that item), which differs from the treatment resulting under a Code provision, then the treaty will prevail provided that the contrary Code provision was not enacted after the treaty became effective. On the other hand, if the contrary Code results from a provision enacted after 1954 and after the treaty effective date, then the Code treatment prevails and no consideration is given to the treaty. Presumably in this circumstance, a taxpayer may argue that the treaty nevertheless prevails (despite the later-enacted Code provision) if the taxpayer can demonstrate a Congressional intent *not* to override the treaty when enacting the Code provisions. Such a negative intention is, we submit, almost impossible to prove.

In summary, the TAMRA changes to Sec. 7852 freeze the effectiveness of pre-1954 treaties as of 16 August 1954. All domestic law changes after that date take precedence over treaties in effect on that date. At this writing, only 9 U.S. tax treaties currently in force fall into this "pre-1954" category.[12]

Treaties entering into force after 16 August 1954 but before the 86 Act are effective only to the extent that their provisions do not conflict with domestic internal law enacted after each treaty's respective effective date. Most existing U.S. treaties fall into this "1954-1986" category. There are 33 active treaties which entered into force between 1954 and 1986 (prior to the

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7. See Section of Taxation, American Bar Association, Issues Paper on Technical Corrections to the Tax Reform Act of 1986 Relating to Tax Treaties, as reprinted in *Tax Management International Journal,* Vol. 17 (August 1988) at 343-355; Rhoades & Langer, Income Taxation of Foreign Related Transactions, §9.02, et seq. (1988); Chapoton, Hearing on S.1350, The Technical Corrections Act of 1987, on 22 July 1987 before the Subcommittee on Taxation and Debt Management, Committee on Finance Senate at 6.
8. Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)), 15 June 1987.
9. Sec. 7852(d) added by Sec. 1012(aa)(A), TAMRA.
10. Conference Agreement, Para. 4130.
11. *Reid v. Covert,* 354 U.S. 1 (1956).
12. The pre-1954 treaties are: Austria, Denmark, Federal Republic of Germany, Greece, Ireland, Netherlands, Pakistan, Sweden and Switzerland. A new treaty with Denmark has been pending since 1980, until certain internal Danish issues are resolved. It is also reported that new treaties with Germany and Sweden will be submitted to Congress during 1989.

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86 Act).[13] All of these "1954-1986" treaties are superseded by the extensive changes enacted by the 86 Act, unless otherwise stated by TAMRA.[14] Only the Bermuda treaty became effective after the 86 Act and prior to TAMRA. TAMRA itself supersedes all treaties existing on 15 November 1988, unless subsequent protocols vary that result.[15] The Treasury Department reports that it is engaged in active negotiations with at least 6 countries[16] for new treaties which will then take precedence over the Code provisions in effect on the respective dates of enactment, unless otherwise expressly stated in the Code.

Of course, Congress can always vary operations of TAMRA's mechanical "later in time" rule by demonstrating a specific, express and clear intent to retain existing treaty benefits despite internal law changes. We suggest, however, that Congress has even less incentive to discover or provide for such conflicts under the "later in time" rule than it previously had when the rule requiring specific abrogation of a treaty was in effect. Rather, Congress has shifted the burden for identifying conflicts to the foreign persons benefiting by the treaty. This is in contrast to other nations which prefer postponing execution of new treaties until their domestic law is settled.[17]

CHANGES TO SEC. 894

Code Sec. 894 serves as a cross reference between treaties and the special Code provisions specifically applied to foreign taxpayers. Prior to TAMRA, this Section stated that a taxpayer could exclude items from gross income and, thus, be exempt from U.S. tax on those items, where such treatment was required by a treaty.

In connection with amendment of Code Sec. 7852(d), TAMRA amended Code Sec. 894 to provide that the Code will be applied to any taxpayer with "due regard" to any treaty obligation of the United States which is applicable to such taxpayer, cross referencing to Sec. 7852(d). The Congressional Committee Conference Report explains that the Code Sec. 894 amendment is not an additional operative rule for determining the relationship between the Code and a treaty, but rather is merely a statement of the constitutional principle that such considerations are relevant in determining tax liabilities.[18] As it presently reads, Code Sec. 894 appears to be an unnecessary and meaningless statement which will, at most, confuse taxpayers as to its intended application.

SPECIFIC CODE-TREATY OVERRIDES

In addition to codifying the "later in time" rule, TAMRA also addresses the interaction between some specific provisions of the 86 Act and tax treaties.[19] Under TAMRA, the following 86 Act provisions will take precedence over conflicting treaties, even though in the 86 Act Congress did not expressly indicate its intent to do so:

(1) Sec. 1201 of the 86 Act which amended the foreign tax credit limitation in Code Sec. 904 and which limits a taxpayer's ability to utilize foreign taxes paid as a credit against U.S. tax liability; and
(2) Sec. 701 of the 86 Act regarding the alternative minimum tax in Code Sec. 55 and the limitation for using the foreign tax credit against a taxpayer's alternative minimum tax liability.

Both of these provisions limit a taxpayer's ability to fully utilize its foreign tax credits against its U.S. taxes. This treatment conflicts with many existing tax treaties that provide for full and unrestricted use of foreign taxes as a credit against U.S. income tax.

Under TAMRA, the following 86 Act provisions are overridden *by* tax treaties in effect on 22 October 1986:[20]

(1) Sec. 123 of the 86 Act which subjects certain scholarship and fellowship grants to U.S. income tax;
(2) Subsecs. (b) and (c) of Sec. 1212 of the 86 Act which, respectively, impose a 4% gross withholding tax on certain transportation income earned by foreign persons and amend the rules that allow a reciprocal exemption from tax for certain transportation income earned by foreign persons;
(3) Sec. 1247 of the 86 Act relating to changes in the exemption from U.S. tax for foreign governments in certain circumstances; and
(4) Sec. 1242 of the 86 Act which treats gain from the sale of assets used in a U.S. trade or business as effectively connected income after the cessation of the taxpayer's U.S. trade or business in certain cases.

In addition, TAMRA provides that in the event of conflict with a treaty, the source of income rules of Sec. 1212(a) of the 86 Act (governing the source of transportation income) and Sec. 1214 of the 86 Act (governing the source of payments from so-called 80/20 companies) will not apply, except for purposes of computing of the foreign tax credit limitation.

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13. The 1954-1986 treaties are: Australia, Bangladesh, Barbados, Belgium, Canada, Cyprus, Egypt, Finland, France, Hungary, Iceland, Israel, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Monaco, Morocco, New Zealand, Norway, Pakistan, People's Republic of China, Philippines, Poland, Romania, Sri Lanka, Thailand, Trinidad/Tobago, Tunisia, the U.S.S.R. and the United Kingdom.
14. See further discussion in text for TAMRA exceptions to treaty override by 86 Act. The treaty with China may be an exception to this rule. It was ratified by the Senate on 22 October 1986 which is also the date the President signed the 86 Act. By the treaty's terms, it officially entered into force 30 days following ratification (21 November 1986). It is unclear how the "later in time" rule applies in these circumstances.
15. To date, the only ratified post-TAMRA protocol has been one to the U.S.–French treaty which was passed by the Senate on 29 December 1988. It is understood that a protocol to the U.S.–Belgium treaty is imminent.
16. Negotiations are reported with: India, Indonesia, Spain, the Netherlands, Portugal and Switzerland.
17. A new U.S.–Denmark treaty has been pending since 1980 until a protocol is agreed to reflect changes in Danish internal tax law.
18. Conference Agreement, Para. 4130.
19. TAMRA, Sec. 1012(aa)(2) and (3).
20. These treaties are listed in notes 12 and 13, supra.

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Certain other treaty conflicts are addressed under TAMRA. For example:

(1) The provision of Sec. 1241 of the 86 Act relating to Code Sec. 884(f)(1)(A) or the so-called "branch level interest tax", to the extent that it treats interest paid in excess of interest deducted as U.S.-source income, will not apply if in conflict with a treaty; and Code Sec. 861(a)(2)(B) which reduces the fraction of U.S. income needed to trigger U.S. withholding tax on dividend payments by a foreign corporation will not apply in the event of a treaty conflict.

(2) The source of income rules of Sec. 1211 of the 86 Act, adding Code Sec. 865 and defining the source of income from certain sales of personal property, will not apply to individuals treated as residents of a conflicting treaty country. Also, to the extent that the source rules of Code Sec. 865(e)(2) conflict with a treaty, the treaty will prevail. A conflict may arise in this situation because, under the 86 Act, income derived by a foreign person from the sale of inventory property that is attributable to a U.S. office is deemed to be U.S.-source income, even though the sale may occur outside the United States and a foreign country may tax that sale. In contrast, for a U.S. resident similarly selling inventory property outside the United States the income is deemed to be foreign-source income. Thus, the non-resident may incur more burdensome taxation than a similarly situated U.S. resident. In this situation, the non-resident may rely on the non-discrimination protection of an applicable treaty for treatment of this income as foreign-source, and thus avoid U.S. tax on that income.[21]

REPORTING REQUIREMENT

To monitor the extent of treaty conflicts, TAMRA adds new reporting and penalty provisions relating to conflicts between treaties and the Code. Code Sec. 6114 requires taxpayers which take a position that a treaty of the United States modifies or overrules domestic tax law must disclose this position on their U.S. income tax returns. If no tax return is filed (based on a treaty exemption from taxation, for example), then the taxpayer must file with the IRS information regarding its position in such manner as may be required under regulations. The relevant regulations have not yet been promulgated. This reporting obligation applies regardless of whether the internal law was enacted before or after the treaty was enacted and appears to extend to any situation in which the taxpayer harmoniously interprets potentially conflicting treaty and Code positions.[22]

Code Sec. 6114 also gives the Treasury authority to waive the disclosure requirement by regulation with respect to classes of cases for which the waiver will not impede the collection of taxes.

As a counterpart to the reporting obligation, TAMRA also enacted Code Sec. 6712 which imposes a penalty for failure to comply with the disclosure requirements of Code Sec. 6114. A penalty of $ 1,000 ($ 10,000 in the case of a "C" corporation) is imposed on each such failure. The disclosure requirements are effective for tax returns due after 31 December 1988.

CONCLUSION

The TAMRA legislation codifies the "later in time" principle that U.S. tax treaties and internal tax laws have equal weight and that, in the event of conflict, the treaty or law enacted latest in time prevails without the necessity to demonstrate a specific intent of Congress to override existing treaty provisions. TAMRA also enumerates those provisions of the 86 Act which override contrary treaty provisions and those existing treaty provisions which override the 86 Act. Finally, TAMRA enacts new reporting requirements and related penalties to monitor compliance with U.S. tax laws by taxpayers utilizing the benefits of income tax treaties.

These enactments raise some basic and troubling issues for other countries who are or hope to be treaty partners with the United States. Existing treaty partners may seek assistance through the mutual agreement procedure available in their treaties to resolve or modify the detrimental effects caused by strict application of TAMRA's "later in time" rule. However, it is readily acknowledged that the mutual agreement procedure is a slow, cumbersome process not easily undertaken. Other than this, there does not appear to be an effective legal means of forcing the United States to comply with its treaty obligations.[23] Therefore, treaty partners may prefer to take their own unilateral actions to counter the result of the TAMRA rule, which then only leads to "lame duck" treaties coupled with continuous, endless treaty revisions to reflect each partner's unilateral actions.

For nations seeking to be or sought as U.S. treaty partners, the issue may turn on whether agreement to exchange of information and mutual assistance provisions are too high a price to pay for substantive treaty "benefits" which may disappear with the next session of Congress.

Overall, the TAMRA enactments simply create greater uncertainty and traps for the unwary foreign investor who seeks to do business or invest in the United States, at a time when the United States can seemingly least afford it.

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21. Conference Agreement, Para. 4130.
22. Ibid.
23. Becker and Würm, "Double Taxation Agreements and the Conflict between International Agreements and Subsequent Domestic Laws", *Intertax* (1988/8-9) at 262.

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Individual Income Taxes in Canada

Arthur Young International

A United States citizen living in Canada must comply with the tax laws of both countries. This article addresses a number of tax questions commonly asked by United States citizens living in or contemplating moving into Canada.

The tax laws of Canada are similar to the United States tax laws in many respects. Residents of both countries are taxed in similar ways and many of the same income elements are subject to tax. However, whereas the United States taxes all of its citizens, no matter where they live, as well as aliens resident in the United States, Canada taxes the world-wide income of Canadian residents only. Non-residents of Canada, like non-resident aliens of the United States, are generally only subject to withholding tax on income derived from Canada.

The Canadian income tax system distinguishes different types of income: employment, property, business, capital gains and other miscellaneous types of income. From the total of net income from all such sources, certain specific items may be deducted to arrive at taxable income. Taxable income is computed in a manner generally similar to the way it is computed under U.S. law.

A major difference between Canada's income tax laws and those of the United States is that Canada does not provide for joint filing by husband and wife. Under U.S. law, there are separate tax rate tables for married individuals. These tables, in effect, divide the family income equally between the 2 spouses, thus subjecting it to tax at lower rates than would be the case if it were taxed separately. In Canada, there is only one tax for all taxpayers regardless of marital status and each individual is required to file an income tax return for any year in which tax is payable. With careful planning it may be possible to achieve tax savings in Canada by income splitting if one spouse has little or no income.

The tax year for individuals in Canada is the calendar year. Tax returns are due on or before 30 April immediately following the year-end; no extensions are allowed. Canadian tax, like that in the United States, is based on a self-assessment system. The taxpayer computes the tax liability and pays any balance due with the return. Late-filed returns are subject to a penalty of 5% of the tax balance outstanding plus 1% per month of the tax balance outstanding, as well as interest calculated at a prescribed rate in effect at that time. Recently, this interest has been between 9% and 11%.

As Canadian income tax is levied on individuals resident in Canada at any time during the year, the determination of an individual's residence is an important consideration. Except in limited circumstances, "resident" is not defined in the Canadian Income Tax Act but is based on common law principles. An individual is resident in Canada for tax purposes if Canada is the place where he regularly, normally or customarily lives. Factors taken into consideration in determining an individual's residence status generally include the permanence and purpose of the stay in Canada, nature of the ties in Canada and elsewhere, and the regularity and length of visits to Canada. Notwithstanding these factors, individuals who are present in Canada for a total of 183 days or more in any calendar year are considered to be resident in Canada for the entire year and are subject to tax on their world-wide income throughout the year even if they did not intend to establish residence in Canada.

Because the Canadian tax system is based on a residence concept, special rules apply to persons resident for only part of a year. The most significant of these rules relates to capital gains taxation, as discussed below.

TAXATION WHILE RESIDENT IN CANADA

TOTAL INCOME

Generally, Canada taxes the same income items as are taxed under U.S. law. Total income includes income earned from an office or employment, property, business capital gains and other income, such as alimony and pensions. The paragraphs that follow briefly describe the more common of these types of income.

Income from office or employment

Income from office or employment generally includes salary, wages (including gratuities) and bonuses. It also includes, with a limited number of exceptions, the value of any employment benefits, such as a company-provided automobile, employment-related low or interest-free loans and, generally, the exercise of employee stock options. However, employer contributions to most pension plans, private health care plans or deferred profit-sharing plans, and group term life insurance coverage of less than C$ 25,000, do not give rise to taxable benefits. Deductions for expenses incurred to earn employment income are more limited than is the case in the United States.

Deferred compensation

A salary deferral arrangement (SDA) includes most arrangements where an employee has the right to receive an amount after the end of the year in lieu of salaries or wages for that year or a prior year and where one of the main purposes of the arrangement is to postpone the payment of Canadian tax. Certain foreign deferred compensation plans, such as the Internal Revenue Code Sec. 401(k) plans utilized in the United States, may be caught by these rules. If the SDA rules apply, the amount of salary deferred in the year and any interest earned on amounts previously deferred will be subject to Canadian tax on a current basis. There is an exception for certain amounts that

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were deferred under a plan established primarily for the benefit of non-residents. Amounts deferred prior to becoming resident in Canada, or deferred in the first 36 months of Canadian residence, will not be caught provided the employee was part of the plan prior to becoming a resident of Canada.

Consequently, an amount deferred after becoming resident in Canada may be taxed on a current basis, while any interest or other amount accruing on the amounts deferred prior to moving to Canada will not be taxable until received. Amounts not taxed on a current basis will be taxed when received. Payments received will generally qualify for transfer to the employees' registered retirement savings plan (see below), enabling the employee to further defer Canadian tax on these amounts.

Income from property and business

Income from property includes interest, dividends and rental income from real property. Dividends from Canadian corporations are effectively taxed at a lower rate as a result of a dividend tax credit. Although dividends are included in income when received, individuals may recognize interest on a cash, receivable or (if an election is made in writing) accrual basis. However, if an individual elects the cash or receivable basis, the recognition of the interest income cannot be extended beyond 3 years.

The Canadian rules for the determination of rental income differ significantly from those in the United States. Generally, expenses relating directly to the earning of rental income, such as interest, property taxes and insurance, are deductible from rental income without restriction. In Canada, depreciation (known as capital cost allowance (CCA)) is generally calculated on a declining balance basis, without reference to useful life or salvage value, by applying a specified maximum rate to the balance in the asset class at the end of the year. Although CCA claims are, within this limitation, completely discretionary, in general, no CCA can be claimed to create or increase a rental loss.

Income from a business is generally calculated on an accrual basis. Even though individuals must have a calendar taxation year, business income may be determined on a fiscal year basis so that the fiscal year's income is taxed in the calendar year in which the year end of the business falls.

Capital gains

As in the United States, capital gains are calculated as the difference between proceeds and the cost for tax purposes. The portion of capital gains to be included in a taxpayer's income is two thirds in 1988 and 1989, and three quarters in 1990 and thereafter; there is no concept of long-term or short-term capital gains. If there is an excess of allowable capital losses (same percentages as above) over taxable capital gains (same percentages as above) in a year, the excess may be carried back to the 3 prior years or carried forward indefinitely to future years. Capital gains on an individual's principal residence are not subject to tax.

A capital gains exemption is available to individuals who are resident in Canada throughout a taxation year. An individual is deemed to be resident in Canada throughout a taxation year for the purposes of the exemption if he is a resident of Canada at any time in the year and throughout the immediately preceding or following taxation year. The lifetime capital gain exemption is C$ 100,000, except for qualified farm property and for shares of small business corporations, both of which qualify for an incremental lifetime exemption of C$ 400,000 (i.e. C$ 500,000 in aggregate).

Special rules apply to the calculation of capital gains upon coming to or leaving Canada (see below).

Other sources of income

Other amounts that must be included in income are receipts from superannuation or pension plans and amounts paid from registered retirement savings plans. Also included are amounts received as a result of loss of office or recognition of long service at retirement and alimony and maintenance payments (deductible to the payor).

DEDUCTIONS FROM INCOME

Individuals may deduct certain items in arriving at taxable income. Some of the more common deductions are described briefly below.

Contributions to pension plans

Contributions to pension plans which are registered in Canada qualify for deduction in Canada, subject to the limits described below. The 2 basic forms of registered pension plans are defined benefit plans and defined contribution plans. The latter are also known as money purchase plans. A defined benefit plan, as the name suggests, is one in which the retirement benefit is defined by the plan. Employee contributions to such plans are fully deductible for tax purposes. The limit on deductible contributions to money purchase plans is C$ 3,500 in 1988.

On the other hand, contributions to foreign pension plans are generally not deductible in Canada, as these plans are not registered in Canada. Furthermore, many United States and foreign pension plans will be considered Retirement Compensation Arrangements (RCAs) for Canadian tax purposes. If the pension plan is an RCA, the pension plan may be subject to a 50% refundable tax on contributions made to the plan on behalf of Canadian residents. In addition, earnings in the plan may also be subject to the 50% refundable tax, unless exempted by an income tax convention. The tax on both contributions and earnings is refundable to the pension plan at the time that the pension amounts are paid to the employee. An exemption from tax is available for the first 5 years an employee is resident in Canada, provided he was a member of the plan prior to moving to Canada. While this tax is imposed on the foreign pension plan, a proposed

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change will affect employees who are members of such plans. A further exemption from this tax is proposed where the employer provides certain information to Revenue Canada. The provision of this information will result in a reduction or elimination of the employee's ability to make a contribution to a registered retirement savings plan.

Contributions to registered retirement savings plans

A registered retirement savings plan, commonly referred to as an RRSP, is the equivalent of a self-contributory pension plan for an individual as opposed to a group plan for employees.

If the individual is not covered by an employer pension plan or deferred profit sharing plan, contributions made by an individual to an RRSP are deductible up to 20% of earned income, with a ceiling of C$ 7,500. Where an individual is a member of a registered pension plan or a deferred profit sharing plan, he may deduct RRSP contributions equal to the lesser of C$ 3,500 and 20% of earned income, minus any contributions to a registered pension plan.

Contributions to an RRSP are not deductible for United States tax purposes and the earnings thereon are also subject to tax under U.S. domestic law. The Canada–United States 1980 Tax Convention provides that a taxpayer may elect that earnings from an RRSP, relating to contributions made while the taxpayer was a resident of Canada, are not subject to tax until received. Therefore, earnings may accumulate in an RRSP tax-free even after an individual ceases to be resident in Canada.

Interest expense

The ability to deduct interest expense is somewhat more restricted in Canada than it is in the United States, where interest is generally deductible. Interest may be deducted for Canadian tax purposes on a paid or payable basis (the method chosen must be followed consistently) only if the funds borrowed have been used for the purpose of earning income from a business or property. Interest paid on loans used to purchase property of a personal nature, including residences, is not deductible. However, tax planning steps can often be taken to convert non-deductible interest into deductible interest.

CALCULATION OF INDIVIDUAL TAX LIABILITY

Federal taxes are calculated at graduated rates. Following the calculation of federal tax, deductions are made for personal and other tax credits (see Chart B). The net amount is referred to as the basic federal tax, on which a 3% federal surtax and provincial taxes are levied. Except for individuals living in Quebec (which collects its own taxes), provincial taxes are calculated as a percentage of basic federal tax and are collected by the federal Government. The federal tax rate table is indexed to increases in the Consumer Price Index in excess of 3%, to prevent inflationary increases in income from attracting higher rates of tax. The 1988 federal and provincial income tax rates for individuals are presented in Chart A, and Quebec income tax rates in Chart C.

Foreign tax credits

From the basic federal tax calculated, an individual may deduct the amount of the foreign taxes paid, within certain limits. Different rules apply in the treatment of foreign taxes paid on business income and non-business income, and credits are determined on a per-country basis.

Foreign taxes on business income are generally creditable against federal taxes payable, subject to limitations imposed by a prescribed formula. Excess credits can be carried back for 3 years and are available for a 7-year carry-forward.

Foreign tax credits on non-business income are deductible against federal and provincial taxes, based on a formula similar to that for foreign business income. There is a restriction on foreign tax credits allowed on certain property income, such as interest and dividends. The maximum foreign tax credit is 15% of the gross foreign property income. Excess foreign non-business income taxes are not eligible for carry-over but all or a portion of the excess is deductible in computing income.

The provision of foreign tax credits in both Canada and the United States and the earned income exclusion for U.S. tax purposes will generally protect U.S. citizens living in Canada from double taxation.

Provincial tax credits

Several provinces provide provincial tax credits against taxes otherwise payable for certain groups of taxpayers. The credits are generally available to taxpayers with lower incomes and are often calculated by reference to rental or other occupancy costs.

Alternative minimum tax

Taxpayers must pay the greater of their ordinary tax liability and their alternative minimum tax (AMT). AMT is a flat 17% of taxable income as re-calculated for AMT purposes, minus certain tax credits plus appropriate provincial tax. The tax will have effect on very few taxpayers. AMT in excess of ordinary tax may be carried forward 7 years and deducted from the ordinary tax liability provided it does not reduce the ordinary tax below the AMT liability.

TAX CONSEQUENCES OF COMING TO OR LEAVING CANADA

There are a number of special tax rules which apply to individuals coming to or leaving Canada, some of the more common of which are discussed below. These and other tax provisions can be extremely complex, with special provisions applying in particular cir-

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cumstances. United States citizens contemplating taking up residence in or leaving Canada should consult with their tax advisors.

Capital gains

In calculating a capital gain or loss on disposition, the cost is generally the actual cost of the property including costs of acquisition. However, for taxpayers who owned capital property (other than taxable Canadian property, a defined term) at the time of becoming a resident of Canada, the property is considered by Canada to have been acquired at a cost equal to the fair market value at the date of becoming a resident.

An individual who ceases to be a resident of Canada is generally considered to have disposed of all capital assets (excluding taxable Canadian property) at their fair market value at the date on which residency in Canada ceases. Any capital gain arising on that disposition must be included in income in the year of departure from Canada. The capital gains exemption, however, may be utilized to offset all or a portion of any such capital gain. In addition, an individual may elect to be deemed to have disposed of taxable Canadian property at the time he ceases to be resident in Canada. The individual may then use the capital gains exemption to offset all or a portion of the capital gain on the deemed disposition. As the exemption is not available to non-residents, the ability to use it would otherwise be lost on leaving Canada.

Taxable Canadian property includes real property situated in Canada, shares of a private corporation resident in Canada and shares of a Canadian public corporation in limited circumstances. Gains on such properties are generally taxable in Canada upon disposition, regardless of residency status. The Canada–United States 1980 Tax Convention generally exempts a non-Canadian resident from Canadian taxation on gains realized on taxable Canadian property, except for real property (or shares in a corporation the main asset of which is real property). An exception to this rule allows Canada to tax such gains where the individual who disposes of the property was resident in Canada for 10 of the 20 years immediately prior to the disposition and at any time in the 10 years immediately preceding the disposition. Canada may also impose tax where the non-resident vendor has a permanent establishment in Canada.

Bonuses

Bonuses received while a taxpayer is resident in Canada are taxable in Canada even if they are based on employment prior to the taxpayer's becoming resident in Canada. Bonuses based on Canadian employment are also taxable in Canada even if they are received after the taxpayer has ceased to be a Canadian resident.

CHART A

Federal income tax rates for individuals (1988)

Taxable income	Tax
C$ 27,500 or less	17%
C$ 27,500 to 55,000	C$ 4,675 + 26% on excess over C$ 27,500
C$ 55,000 and over	C$ 11,825 + 29% on remainder

Federal tax credits may be deducted from the federal tax calculated as above (see Appendix B). Also, the 3% federal surtax applicable to individuals is not reflected in the foregoing table. To the resulting amount of federal tax, the taxpayer must then add the appropriate provincial tax with respect to income earned in any province. The provincial tax (except for Quebec) is computed by applying the appropriate provincial rate to the basic federal tax. The standard provincial and territorial rates for 1988 are as follows:

Alberta	46.5%[2]
British Columbia	51.5
Manitoba	54.0[2,3]
New Brunswick	60.0
Newfoundland	60.0
Nova Scotia	56.5
Ontario	51.0[3]
Prince Edward Island	56.0[1]
Saskatchewan	50.0[2,3]
Northwest Territories	43.0
Yukon Territory	45.0

1. Prince Edward Island's rate increased from 55% to 57% effective 2 July 1988. A 10% surtax on provincial income tax in excess of $ 12,500 is also effective 1 July 1988.
2. Alberta, Manitoba and Saskatchewan impose a flat tax of 0.5%, 2% and 2% of net income, respectively. The table assumes net income equals taxable income.
3. Manitoba, Ontario and Saskatchewan impose surtaxes on upper income taxpayers.

(These rates are subject to change.)

CHART B

1988 federal personal tax credits

	Maximum amount
Basic	C$ 1,020
Married when spouse earns income below a specific limit	C$ 850
Dependants under 18 who earn income below a specific limit	C$ 65 First 2 children C$ 130 Additional
Dependants age 18 and over who are infirm and earn income below a specific limit	C$ 250
Age 65 and over in the tax year	C$ 550
Disabled	C$ 550
Pension	17% of eligible pension income max. C$ 170)
Tuition	17% of tuition
Education	C$ 10 per month
Charitable donations	17% of first C$ 250 of donations plus 29% of excess donations
Medical expenses	17% of expenses in excess of 3% of net income (or C$ 1,500 if lower)
Canada Pension Plan/Unemployment Insurance Premiums	17% of contributions

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Part-year residents

Taxpayers coming to or departing from Canada during a taxation year will be taxed on their world-wide income for the portion of the year that they are resident in Canada. They are generally entitled to the same deductions and tax credits as full-time residents, with the exception of personal credits which are pro-rated for the number of days during the year that the taxpayer was resident in Canada.

CHART C

1988 Quebec provincial income tax rates

Taxable income	Tax
C$ 6,999 or less	16.0%
C$ 7,000 to 13,999	C$ 1,120 + 19.5% on excess over C$ 7,000
C$ 14,000 to 22,999	C$ 2,485 + 21.5% on excess over C$ 14,000
C$ 23,000 to 49,999	C$ 4,420 + 24.5% on excess over C$ 23,000
C$ 50,000 and over	C$ 11,035 + 26,0% on remainder

(These rates are subject to change)

1988 Quebec tax credits

Basic personal	C$ 1,056
Other credits:	
– person living alone	C$ 180
– married person and spouse who earns no income	C$ 1,056
– for persons 65 years of age and over	C$ 440
– for persons suffering from a physical or mental handicap	C$ 440
– for children and other dependants, 18 and over when studying full-time, who have no income:	
– general	
first child	C$ 446
second and subsequent children	C$ 379
– post secondary studies	C$ 305 per term
– for children and other dependants age 18 and over when they have no income	C$ 379
– for children and other dependants age 18 and over and disabled (credit of C$ 379 cannot also be claimed)	C$ 1,056

Quebec residents are entitled to a reduction of 16.5% of the basic federal tax. Quebec taxes are calculated on a separate tax return and are remitted to the province directly. The filing deadline and penalties for late filing are similar to those for federal income tax purposes.

Conference Diary

MAY 1989

Internationale Acquisitiecontracten. Noordwijk aan Zee, 10 May (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

15th Annual Conference of International Tax Planning Association. Lisbon, 18-19 May (English):
To: Elisabeth Walters, Conference Director, International Tax Planning Association, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

Transcontinental Trusts. The Third Annual Conference on the Use of Trusts and their Underlying Companies in International Planning. London, 22-23 May (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Steuertagung Schweiz–Deutschland 1989. Zürich, 22-23 May (German):
Zentrum für Unternehmungsführung, Schulstrasse 7, CH-8802 Kirchberg-Zürich, Switzerland.

Internationaal Ondernemen en de Fiscus. Rotterdam, 24-25 May (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Enterprise 1992 – Juridical and Economic Problems; Proposals for Solution. Milan, 25-28 May (Italian):
C.I.R.G.I.S., Segretaria, Via Manzoni, 45 – 20121 Milano, Italy.

Holdingconstructies – Een Overzicht van de meest Recente Wijzigingen en Toekomstige Ontwikkelingen. Utrecht, 26 May (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

JUNE 1989

Taxation of Branches and Subsidiaries. Brussels, 1-2 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Inspelen op Oort – Een nieuwe fiscale strategie voor (on)belaste vergoedingen en aftrekmogelijkheden. Amsterdam, 5 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Fundamental Elements of U.S. Federal Taxation; U.S. Taxation of Corporate Reorganizations; U.S./International Taxation: Tax Strategies for Cross Border Activities. London, 5-10 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Uitstel van winstneming. Garderen, 8-9 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Anti-Avoidance and Tax Treaty Policies and Practice in the Asian-Pacific Region. Wellington, 9-12 June (English):
Conference Manager, Anti-avoidance Tax Policies in Asia and the Pacific, Institute of Policy Studies, Victoria University of Wellington, P.O. Box 600, Wellington, New Zealand.

Wet Ketenaansprakelijkheid, Amsterdam, 12 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Werken met de Nieuwe Invorderingswet. Nieuwegein, 13 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Jersey – A Responsible Offshore Centre. St. Helier, 13-14 June (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants, United Kingdom NN17 1PL.

Strittige Fragen aus der Prüfung von Auslandsbeziehungen – Praktikerseminar. Bonn-Bad Godesberg, 14 June (German):
BS-Gesellschaft für Unternehmerinformation mbH, Mecklenburger Strasse 5, Postfach 240124, 5300 Bonn 2, Federal Republic of Germany.

The Use of Tax Havens and Low Tax Finance Centres. Geneva, 15-16 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Starting Business in Japan. Brussels, 26-27 June (English):
Customer Service Department, Management Centre Europe, Postbus 95, NL–3417 ZH Montfoort, The Netherlands.

1989 Offshore Investment Convention & Exhibition. London, 27-29 June (English):
The Offshore Investment Convention Secretariat, Thomas Reed Publications Limited, 80 Coombe Road, New Malden, Surrey KT3 4QS, United Kingdom.

SEPTEMBER 1989

Joint Seminar of the U.S. and British Branches of I.F.A. prior to the RIO Congress. Coral Gables. Miami, 7-8 September (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

I.T.P.A. Workshop. Monte-Carlo, 14-15 September (English):
To: Elisabeth Walters, Conference Director, International Tax Planning Association, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

Fundamental Elements of U.S. Federal Taxation; U.S. / International Taxation; U.S. Individual / Expatriate Taxation. Lésigny, 18-23 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London, WIM 5FT, United Kingdom.

Praktiker-Seminar zur Steuerreform 1990. Wiesbaden, 22 September; Stuttgart, 23 September; München, 29 September; Würzburg, 30 September (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

NOVEMBER 1989

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

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PORTUGAL:

Withholding Taxes

William T. Cunningham

Mr. Cunningham is a partner of Arthur Andersen & Co. He has been in charge of the firm's Portuguese Tax Practice since 1983. Previously, he spent 9 years in the Dublin office of Arthur Andersen & Co. working on Irish, U.S. and international tax matters. He is a member of the Institute of Chartered Accountants in Ireland, the Institute of Taxation in Ireland, the Portuguese Fiscal Association and the International Fiscal Association. He holds a degree in Commerce from the National University of Ireland. He has lectured extensively on taxation matters for both Irish institutes and has co-authored several Arthur Andersen & Co. tax publications.

With the 1989 reform, the Portuguese tax system places greater than ever reliance on collection of tax at source. This has the combined effect of combating tax evasion and of shifting a substantial administrative burden from the State to the taxpayer. The accompanying table sets out the types of payment that attract Portuguese withholding and the applicable rates. In consulting the table, the following should be borne in mind:

(1) Tax treaties may reduce the withholding rates on dividends, interest and royalties. However, not all Portugal's tax treaties operate to limit local tax at source, and it is common for U.K. residents to wait up to 5 years for a refund of excess Portuguese withholding. In addition, compliance with the related formalities is a necessary precondition of withholding reduction. The following are the maximum rates of Portuguese tax under its current 12 tax treaties.

TAX TREATIES[1]

	Dividends	*Interest*	*Royalties*
Austria	15%	10%	10 or 5%
Belgium	15%	15%	5%
Brazil	15%	15%	15 or 10%
Denmark	15 or 10%	15%	10%
Finland	15 or 10%	15%	10%
France	15%	12%	5%
Germany	15%	15 or 10%	10%
Italy	15%	15%	12%
Norway	15 or 10%	15%	10%
Spain	15 or 10%	15%	5%
Switzerland	15 or 10%	10%	5%
United Kingdom	15 or 10%	10%	5%

(2) The reduced withholding rates for interest on bonds issued in 1989, on Government and related debt and for dividends paid by quoted and privatized companies are as yet only legislative authorizations and require a specific Decree-Law, the long-awaited Statute on Tax Incentives, to be effective. This is expected in the second half of April 1989.

(3) Withholding is usually a payment on account, with the recipient declaring the gross amount in his tax return and claiming a tax credit for any withholdings. An exception is the tax withheld from payments to resident individuals of bank interest, income from nominative or bearer securities and gambling or lottery winnings which constitutes full settlement of the related tax liability, although the taxpayer may opt to report it (except with respect to winnings mentioned above which are mandatorily taxed under a final withholding) and use the tax credit mechanism. Another instance of full settlement is the tax withheld from income paid to non-residents who do not have a permanent establishment in Portugal to which that income is attributable, with the exception of rental received by a non-resident company from Portuguese property. Thus foreign corporate owners of Portuguese rented property cannot avoid the obligation to file a corporate tax return and the attendant possibility of having the property considered as a permanent establishment liable at the 36.5% corporate rate instead of the non-resident 25% rate.

(4) Tax reform has not abolished the nuisance factor of the substitute gift and inheritance tax withheld at a rate of 5% from dividends and interest paid on bearer shares and bonds. During 1988, the withholding obligation was extended to these shares and bonds even where they had been registered or deposited. The draft legislation on tax incentives contains authorization for the Government to extend further this withholding to dividends and interest paid on registered or deposited as well as nominative shares (but not bonds).

(5) For employers paying non-variable wages, 2 alternative withholding systems are available:

(a) Tax tables, graduated in extremely small steps, for monthly earnings up to 250,000 Esc. (excluding directors' fees); the effective rates range from zero to 27%, and the system is not cumulative until December, when an annual table is substituted and any necessary year-end adjustments to the withholding are made.

1. Negotiations on a treaty with the United States re-open in Washington on 3 April 1989.

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(b) A formula-based system, compulsory in relation to monthly earnings over 250,000 Esc. (and to directors' fees regardless of the amount), optional below this level; this attempts an estimate of the tax liability for the year, and divides it in 14 equal withholding instalments, in line with the number of monthly salaries receivable by Portuguese employees (an extra month's pay is given at holiday and Christmas time). Since this calculation ignores such tax-deductible items as health expenses, alimony commitments, home loan interest, etc., it results in excess withholding refunded only after filing a tax return in February of the following year.

(6) For employers paying variable wages (e.g. commissions, payments to piece workers, part-time or seasonal workers), a separate table with rates of between zero and 38% applies. This is cumulative and takes account of prior payments to each employee during the year.

WITHHOLDING TAXES – STATUS 23 MARCH 1989

Tentative – Incorporating rate reductions as yet only proposed in draft legislation on tax incentives in relation to interest & dividends Income type	Resident or non-resident with perm. est.	Non-resident without perm. est.	Individual Resident	Individual Non-resident	Additional 5% substitute gift/ inherit. tax	Legislastion already enacted?
Employment (incl. pensions)						
Fixed up to 250,000 Esc./mth./2,250,000 Esc./year	N/A	N/A	Tax tables 0 to 27%	25%	No	Yes
Fixed, 250,000 Esc./mth. or more/ 2,250,000 Esc./year or more	N/A	N/A	Formula-based 0 to 40%	25%	No	Yes
Variable monthly	N/A	N/A	Tax tables 0 to 38%	25%	No	Yes
Self-employed professional fees	N/A	N/A	16%	16%	No	Yes
Fees of members of corporate bonds	20%	25%	Tax tables 0 to 27%			
Fees of shareholder-members of corporate bonds	20%	25%	Formula-based 0 to 40%	25%	No	Yes
Income from intellectual or industrial property, from the provision of industrial, commercial or scientific "know-how"	16%	15%	16%	15%	No	Yes
Rentals of agricultural, commercial or scientific equipment	0%	15%	16%	15%	No	Yes
Gambling & lottery winnings	25%	25%	25%	25%	No	Yes
Property rentals (where tenant has organized accounts)	16%	25%	16%	16%	No	Yes
Technical assistance payments & royalties	16%	15%	16%	15%	No	Yes
Interest on:						
Bank deposits	20%	20%	20%	20%	No	Yes
Corporate bonds – General	25%	25%	25%	25%	Bearer only	Yes
Corporate bonds issued in 1989 – Convertible	25%	25%	25%	25%	No	
Corporate bonds issued in 1989 – Non-Convertible	20%	20%	20%	20%	Yes	
Corporate bonds issued in 1988 – Convertible	0%	0%	0%	0%	No	Yes
Corporate bonds issued in 1988 Non-convertible	6%	6%	6%	6%	Yes	Yes
Corporate bonds issued in 1987 with term less than 8 years	10%	10%	10%	10%	Yes	Yes
Corporate bonds issued in 1987 with term 8 years or more	0%	0%	0%	0%	No	Yes
Corporate bonds issued in 1987 after 15 March – Convertible	0%	0%	0%	0%	No	Yes
Government & related debt:						
Issued in 1986, 1987 & 1988	0%	0%	0%	0%	No	Yes
Issued in 1989-1 (before tax incentives law)	25%	25%	25%	25%	No	No
Issued in 1989-2 (after tax incentives law)	20%	20%	20%	20%	No	No
Issued in 1989-3 (after tax incentives law)	0%	0%	0%	0%	No	No
All other nominative or bearer securities	25%	25%	25%	25%	Yes	No
Any other applications of capital	16%	20%	16%	20%	No	Yes
Dividends from Sociedades Anónimas:						
Quoted	20%	20%	20%	20%	Yes	No
Unquoted	25%	25%	25%	25%	Bearer only	Yes
Privatized	15%	15%	15%	15%	Yes	No
Dividends from Sociedades por Quotas	16%	20%	16%	20%	No	Yes

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COLOMBIA:

The Taxation of Income from Business and Capital

An Overview of Objectives and Alternatives

Luis Guillermo Morales

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FOREWORD

This article summarizes and analyzes the introductory chapter of the report entitled *The Taxation of Income from Business and Capital in Colombia* ("the Report") which was prepared by a commission of international tax experts, headed by Professor Charles E. McClure, Jr. The Report is intended to assist the Colombian Government in its current deliberations on whether and how to modify the provisions for inflation adjustment contained in the 1986 legislation reforming the Colombian income tax.[1]

I. INTRODUCTION

Law 75 of December 1986 fundamentally changed the Colombian income tax system. Tax thresholds were raised, withholding was made a final tax for many taxpayers and the top bracket rate paid by individuals was reduced from 49% to 30%.

The changes made to the treatment of income from business and capital were particularly important. The taxation of corporations (sociedades anónimas) and limited liability companies (sociedades limitadas) has been unified by subjecting the taxable income of both entities to the 30% rate and excluding dividends paid by corporations and partners' shares in the earnings of limited liability companies from the tax base of individuals. Interest income and expense are to be indexed for inflation; except in the case of interest income received by individuals from financial institutions and other payors subject to Government regulation (which immediately qualifies for indexation), this inflation adjustment is to be phased in over a 10-year period beginning in 1986. Inflation adjustment has not been extended to depreciable assets or to inventory accounting, which already benefit from accelerated depreciation and the use of last-in first-out (LIFO) accounting.

Law 75 provides the Colombian Government with "extraordinary powers" (facultades extraordinarias) to, inter alia, introduce further changes in the law so as to eliminate the effects of inflation from the measurement of taxable income.[2] The purpose of the Report is to guide the Government in fulfilling that mandate.

The Report goes far beyond advocating a reform of the existing income and net wealth taxes. It considers a more drastic reform, i.e. a system of direct taxation based on consumption rather than income. The proposed reform in many ways presents an attractive concept but it is a concept which has not been implemented in any country.[3]

1. See James Leavy, "Tax Reform Adopted By Congress", 41 *Bulletin for International Fiscal Documentation* 3 (1987) at 142 and *Taxation in Latin America*, Ch. Colombia 602(b) and (c) and 10.03(e).

2. See Art. 90 of Law 75. Although most of the extraordinary powers were effective for somewhat longer than one year (until 31 December 1987), the powers relating to the elimination of inflationary effects from the calculation of taxable income remained in effect until the end of 1988. By virtue of the extraordinary powers, the Government adopted Decree 2687 of 26 December 1988 which provides systematic adjustment for crucial items of income and expense, including interest, capital gains, depreciation and similar allowances, and cost of goods sold from inventories. Decree 2687 follows an "integrated" approach to inflation adjustment of the type employed in Chile. The result of this approach is expected to be an "inflation-adjusted" income tax in which only real income would be taxed. Inflation adjustments must be reflected in the taxpayers' financial statements and shall be used to determine commercial profits and taxable bases for income and complementary taxes. This system of inflation adjustment is optional until 1991. As from taxable year 1992, all taxpayers who are under the obligation to keep accounting records (110,000 businesses and 40,000 individuals) must adopt the system. For a discussion of this Decree, see Morales, "New Tax Measures", 43 *Bulletin for International Fiscal Documentation* 4 (1989) at 181.

3. *Editor's note:* A system of direct taxation based on expenditure or consumption does exist (albeit in an imperfect form) in Bolivia and Chile.

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II. ALTERNATIVE SOLUTIONS

Before the December 1986 reforms, little systematic allowance was made for inflation in the measurement of income under the Colombian income tax. As a result, taxable income could be either understated or overstated, resource allocation was distorted by taxation as it interacted with inflation, and equity suffered. The higher the rate of inflation the more important these deficiencies.[4]

There are 2 ways to deal with this situation. One is to provide systematic inflation adjustments for crucial items of income and expense, including interest, capital gains, depreciation and similar allowances, and cost of goods sold from inventories.[5]

The result of such an approach would be an "inflation-adjusted" income tax in which only real income would be taxed.[6] The 1986 reforms embraced this method although the reforms stopped short of the complete adjustments required to make the measurement of real income accurate and independent of the inflation rate. Consistent application of this approach would also produce a net wealth tax (and a measure of presumptive income) based on current values of assets and liabilities. The 1986 reforms made little progress in this area.

Alternatively, a system of direct taxation based on consumption rather than on income could be adopted. The consumption-based tax could be imposed at both the company level and the partner or shareholder level, or it could only be imposed at the company level depending upon the approach selected for individual taxation, i.e. the Individual Cash Flow ("ICF") approach or the Individual Tax Prepayment ("ITP") approach discussed in Chapters 8 and 9 of the Report. Under the ICF, deductions are allowed for savings in any legitimate investment accounts, which are generally referred to as "qualified accounts". All withdrawals from such accounts, including both interest and principal, are fully included in the tax base. Thus, interest, dividends, capital gains, rents and the initial amount of the investment (for which a deduction was allowed) are taxed only when withdrawn from a qualified account.

An alternative method of implementing a consumption-based tax at the individual level would be to exclude the yield on capital income from the tax base. Consequently, in contrast to the ICF approach, both the saving and the receipt of capital income at the individual level would be ignored for tax purposes. Interest income, dividends and capital gains would not be included in the individual tax base and interest payments would not be deductible. As a result, the individual tax base would consist only of labour income, i.e. wages, salaries, etc.

A consumption-based tax enjoys a considerable advantage in that inflation adjustment is generally unnecessary because all quantities relevant for calculation of tax liabilities are measured on a cash flow basis in current-year pesos (i.e. taxes are paid when cash is received and deductions are allowed when cash is disbursed). Under one variant of a consumption-based tax, businesses are allowed immediate deductions for all purchases, including those of depreciable assets and inventories. Interest income of businesses is exempt; dividends paid and interest expenses are not deductible. At the individual level, interest income and dividends are exempt and interest payments are not deductible.[7]

A consumption-based tax is also advantageous because realization is tied to cash flow. The timing of cash flow is a relatively easily identifiable event. By comparison, under an income tax it is much less obvious when income and expense should be recognized for tax purposes. For example, if taxable income is to reflect economic income, depreciation allowances for tax purposes must reflect economic depreciation (the decline in the value of a depreciable asset as measured by its ability to generate a future flow of income). It is difficult, however, to know the appropriate pattern of depreciation allowances to use for tax purposes. Many other difficult "timing" issues (sometimes called "time value of money" issues) must also be addressed in designing an income tax.[8] None of these issues arise under a consumption-based tax.

Compared to the largely unindexed pre-1986 income tax, the policy reforms needed to establish an indexed income tax (including those of Law 75) can be perceived as either a final destination or as an intermediate step toward a variant of the direct consumption-based tax outlined in the Report. A consideration of the tax treatment of several key items of income and expense under the income and consumption-based regimes is illustrative. The disallowance of the "inflation premium" in interest payments is necessary under an inflation-adjusted income tax. However, this partial disallowance of interest income and expense can also be seen as a step towards the full disallowance necessary under the consumption-based tax.[9] Similarly, the exemption of dividends under the 1986 reforms can be perceived as an ad hoc and inexact method of integrating corporate and individual income taxes (although

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4. It may be worthwhile to note that the inflation adjustment of taxable income (and of monetary values specified in the tax law) need not imply the indexation of wages, income, etc., of the type that has been practiced in several Latin American countries (e.g. Brazil).
5. One can either follow a "piecemeal" or ad hoc approach to inflation adjustment or one can adopt an "integrated" approach of the type employed in Brazil and Chile.
6. See footnote 2, supra.
7. The description in the text refers to the ITP approach as set forth in the Report, where taxes are imposed only at the company level. The distinction between ITP and the alternative ICF (where taxes are also imposed at the level of partners and shareholders under certain circumstances) is not important for purposes of this article.
8. How timing issues are resolved is important to both taxpayers and the Government because of the "time value of money". Simply stated, if the relevant discount rate is 25%, a one year postponement of a tax payment of 100 pesos reduces the present value of the payment to 80 pesos.
9. This characterization is more accurate for the "piecemeal" or ad hoc approach to inflation adjustment of interest income and expense that underlies Law 75 than for the integrated approach used in Brazil and Chile. The use of accelerated depreciation may actually be closer to consumption tax treatment than is the conceptually more appropriate system of inflation adjusted allowances for economic depreciation.

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an appropriate method for Colombia) or as a component of a consumption-based tax.

The consumption-based alternative is clearly simpler than an inflation-adjusted income tax; for this reason it is called the simplified alternative tax ("SAT") in the Report. However, other factors must be taken into account in choosing between these 2 alternatives. First, the SAT essentially exempts all business income and capital from tax.[10] Thus it raises equity concerns, particularly in Colombia, which has a tradition of attempting to achieve progressive taxation and in which the ownership of capital is highly concentrated. Second, if Colombia is to retain its net wealth tax (impuesto de patrimonio), as recommended by the Report, the simplicity advantages of the SAT are less than if no net wealth tax was imposed. This is true because many (but not all) of the complexities of the income tax that would be avoided under the SAT must be addressed in calculation of net wealth. Third, the calculation of presumptive income, an important anti-evasion "backstop" under the present income tax regime (which is based primarily on net wealth), is simply inconsistent with adoption of a consumption-based tax. Finally, there is at least some uncertainty whether the SAT would be eligible for the foreign tax credit allowed by some capital-exporting countries, in particular the United States.

The Report fully describes these 2 basic alternatives, examines the pros and cons of each and provides detailed proposals for the implementation of each approach, including transition measures. The choice between these 2 tax systems is a difficult one and it is not simplified by the fact that no country has practical experience with a tax such as the SAT[11] nor are the Colombian data needed for a complete evaluation readily available. The decision to adopt the SAT must therefore be based largely on conceptual reasoning rather than empirical analysis. Partly for these reasons, the Report makes no firm recommendation as to which of the 2 alternatives should be adopted.

The remainder of this article describes briefly the objectives a tax system should achieve and applies the criteria used in the Report to provide an assessment of the 2 basic alternatives. This discussion should be useful to those responsible for choosing between the systems.

III. OBJECTIVES

The tax system of a country ideally should satisfy certain basic objectives. These include simplicity, fairness or equity, economic neutrality (or more generally economic efficiency) and consistency with economic development. In addition (or as aspects of these primary objectives), the tax system must yield adequate revenue, it must not needlessly discourage investment in the country and it must not result in unnecessary sacrifices of tax revenues in favour of foreign Governments.

A. Simplicity

Simplicity is an important tax policy objective in all countries. After all, little is gained from enacting an elegant system that theoretically meets the goals of equity and neutrality (as well as the other goals described below), but in fact does not achieve either because it cannot be implemented effectively. Simplicity is particularly important in developing countries where the expertise required for an effective tax administration is scarce. In many instances it may be necessary to sacrifice conceptually desirable refinements in the definition of the tax base in order to maintain the system, economize on scarce talents and achieve rough justice.

B. Fairness

Fairness or tax equity has 2 dimensions, the horizontal and the vertical. Horizontal equity requires that taxpayers with the same real income who are in similar circumstances in other relevant respects pay roughly the same amount of tax. Knowledge that other taxpayers of equal income are paying vastly different amounts of tax can undermine taxpayer morale and compliance incentives.

Horizontal equity may also be significant from a political perspective. Horizontal equity is violated in several ways: when certain items of income are exempt or taxed at preferential rates, when extraordinarily high rates are applied to certain items of income, when only some expenses of earning income are allowed as deductions or if deductions or credits are allowed for expenditures that do not represent costs of earning income.[12] Horizontal equity is not achieved if some sources of income more easily escape tax than other sources.

The absence of precise inflation adjustments can cause severe horizontal inequities even in a system that would be judged to be fair from the perspective of horizontal equity (in the absence of inflation) because income from business and capital is measured incorrectly.[13] For example, in a time of rapid inflation,

10. As stated in the text, the SAT exempts all income, including interest income, from tax. For marginal investments, tax revenues are equal in present value to the tax reduction that resulted from prior expensing of investments, less the tax cost of deductions for current investments. The SAT, however, may actually yield revenues related to business and capital in a given year since the Government shares in the original investment via expensing (in essence the Government is a "silent partner" in all private sector investments under the SAT). This is explained in detail in Chapter 8 of the Report.

11. See footnote 3.

12. Of course, the fact that "equal treatment of equals" is not achieved does not necessarily mean that a tax system is viewed as horizontally inequitable by taxpayers; that depends on taxpayer perceptions of whether particular instances of differential treatment are justified. The qualification that taxpayers should be "in similar circumstances in other relevant respects" allows wide latitude for the inclusion of commonly-employed features of individual income taxes such as personal exemptions and deductions for medical expenses.

13. The failure to adjust magnitudes that are fixed in monetary (peso) values, such as personal exemptions, can also compromise both vertical and horizontal equity by allowing inflation to erode these nominal amounts. Most important nominal values in the Columbian income tax have been fully indexed for inflation since 1979 (and partially indexed since 1975).

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interest income and capital gains are overstated in an unindexed but otherwise "ideal" income tax. By comparison, interest deductions are overstated but depreciation allowances are understated. One purpose of inflation adjustment is to prevent these horizontal inequities by producing a more accurate measure of real income. Similarly, timing issues must be handled adequately if income is to be measured accurately.

Vertical equity involves the pattern of differentiation of tax burdens experienced at different income levels, i.e. the progressivity of the tax system (tax as a percentage of income at various income levels).

There is no scientific basis for judging the proper degree of progressivity in the tax system of a country or in any component of a tax system (such as the income tax). This is essentially a socio-political decision. It is generally agreed, however, that aggregate tax burdens should not fall as a percentage of income as income rises (i.e. regressivity is inappropriate). Some observers believe that proportional taxation (taxation equal to a given percentage of income at all income levels) is appropriate, but the majority of observers probably agree that some degree of progressivity (an increase in the percentage of income taken by tax as income rises) is appropriate.

Annual income has traditionally been accepted as the most satisfactory measure of ability to pay. Others, however, have argued that annual consumption is a better measure of taxpaying ability; the Report rejects that view. More recently, it has been argued that income received over a lifetime is a better measure than either of these measures. Under certain circumstances, a tax based on consumption that includes the value of gifts, bequests and inheritances in the tax base of the donor (as well as in that of the donee) approximates in present value terms a tax based on lifetime income.[14] While these exact conditions are unlikely to prevail in actuality, it may be that a consumption-based tax, with gratuitous transfers being included in the tax base of both donor and donee, approximates a tax on lifetime income closely enough to be preferable to a tax on annual income.[15] This has important implications for both horizontal and vertical equity.

Perhaps the most important implication involves the interpretation of the exemption of income from business and capital under the SAT (see text above). Judged from the viewpoint that accepts annual income as the proper measure of ability to pay, this exemption appears to constitute a fundamental violation of both horizontal and vertical equity. By comparison, under the viewpoint that accepts lifetime income as the proper measure of taxpaying ability, the SAT, with inclusion of gifts, bequests and inheritances in the tax base of both the donor and donee, is consistent with both aspects of equity.

Another important equity issue involves taxpayer perceptions. If taxpayers regard annual income as the proper measure of ability to pay, the SAT is likely to be perceived as unfair, despite sophisticated arguments indicating that it is consistent with a lifetime income view of equity.

In Colombia there is an additional element in the debate over tax equity that is commonly not present in other countries. The Colombian net wealth tax provides an opportunity to augment the progressivity produced by graduated rates under the income tax. It might be thought that the existence of a net wealth tax is logically inconsistent with the consumption-based SAT which exempts income from business and capital. Yet the Report proposes that if the SAT is adopted, the net wealth tax should be retained in order to prevent an unacceptable reduction in the progressivity of the Colombian tax system. This simply reemphasizes that the primary advantage of the SAT is its administrative simplicity. As noted above, this simplicity advantage of the SAT is less important in Colombia than it might be in other countries, precisely because administration of the net wealth tax requires many of the complexities of a tax on real economic income that the SAT avoids.[16]

C. Economic neutrality

A tax system that is not neutral can do substantial damage to an economy by distorting choices about what to consume, what to produce and how to organize and finance production. Consequently economic neutrality and low tax rates are commonly high on the list of objectives for tax reform. For present purposes, neutrality is interpreted as calling for uniform taxation at relatively low rates of all real economic income passing through the marketplace (or of all income used for consumption, gifts, bequests and inheritances under a consumption-based tax), regardless of its source of use.[17]

Of course, in any given country, market imperfections raise questions about the case for economic neutrality and uniform taxation. Where such imperfections exist, some offsetting non-neutrality in the tax system might, in principle, be desirable. An obvious example would be relatively heavy taxation of activities which generate negative results such as pollution. Indeed, the theoretical case for differentiation in taxation goes beyond even that. The theory of optimal taxation

14. Ensuring the inclusion of gifts and bequests in the tax base of the recipient is very difficult from an administrative standpoint. Evasion is always an issue because it is extremely difficult for tax administrators to discover unreported transfers, especially between family members. However, once gifts and bequests received have been identified they should be included in the tax base of the recipient at fair market value. Accurate valuations are frequently difficult to obtain, in particular for interests in closely-held businesses and for items which are traded infrequently (e.g. art). For SAT to be a fair tax, serious efforts must be directed to administer and enforce this treatment of gifts and bequests as effectively as possible.

15. It is worth mentioning that all member nations of the Organization for Economic Co-operation and Development (OECD) that have recently considered the lifetime income alternative have rejected it. This fact need not be dispositive in Colombia where administrative issues must be given greater weight than in developed countries which are members of the OECD.

16. This issue can also be seen from a somewhat different perspective; some would find the distributional effects of the SAT acceptable only because of the existence of the net wealth tax.

17. In a developing country it is often difficult to tax all market transactions. It is thus desirable to have low tax rates in order to minimize distortions.

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suggests that economic welfare is maximized if the heaviest taxes are imposed on goods and services for which either supply or demand is relatively insensitive to price or price-inelastic. Practical considerations suggest, however, that the wisest policy is generally to attempt uniform taxation of all income or of all consumption.[18]

D. Revenue neutrality

Analysis of the amount of tax revenue that should be collected by the Colombian Government goes far beyond the scope of the Report. Accordingly, it is assumed (again without making any recommendations) that any tax reform should be "revenue neutral", i.e. that the reformed system should yield roughly the same amount of revenue as the existing one. As with distributional neutrality, this objective can easily be modified, within limits, by changing tax rates.

E. Economic development

To some extent, encouraging economic development can be seen as merely an aspect of economic neutrality, albeit an important one. Seen in that light, a neutral tax system will be conducive to economic development and one that is not neutral will inhibit development.[19] Particularly important in this regard is the neutrality of the SAT toward the choice between current consumption and saving for future consumption. Whereas the traditional income tax penalizes saving and encourages current consumption, a tax based on consumption is neutral in this regard.[20]

Depending on how it is structured, an income tax system can be more or less conducive to economic development. High tax rates are likely to cause substantial disincentives for saving, investment and work effort.[21] Perhaps more important, especially for savings and investment, are other structural features of the tax system. Rapid depreciation allowances and generous investment incentives encourage investment, but failure to allow for inflation in calculating depreciation allowances discourages investment.

Domestic private saving may also be encouraged or discouraged by structural tax policy. Particularly important in this regard is the fact that inflation erodes the principal amount of debt. Failure to take this into account encourages borrowing and discourages saving. Of course it is almost certainly more effective to use a reduction in the Budget deficit as a means of increasing aggregate saving than to rely on changes in the structure of taxation to boost private saving.[22] Moreover, it should be remembered that policies that increase domestic investment do not necessarily increase domestic saving, or vice versa. An increase in investment not matched by an increase in saving must be financed by the influx of foreign capital.

In a relatively small, open, capital-exporting country like Colombia, the tax treatment of income from international investment is significant. This involves the treatment of income earned by foreign investors in the country as well as the treatment of income from domestically-owned foreign assets. An important objective of tax reform is to improve the climate for investment for both Colombians and foreigners. However, we must not be over-zealous in the pursuit of this objective, as has often been the case in Colombia and other countries. Fairness and simplicity (not to mention revenues) must not be sacrificed for the sake of increased investment. Perhaps more important, it should be recognized that it is not always true in the investment field that "more is better".[23]

The Report indicates that marginal effective tax rates on much of the debt-financed investment in Colombia are negative, meaning that because of preferential tax treatment an attractive private return can be earned on investments which have a relatively low or even negative rate of return to the nation – clearly an undesirable state of affairs.[24] Inflation adjustments of interest income and expense such as those enacted in 1986 can help remedy this situation.

F. Interaction with foreign taxes

The interaction between the income taxes of Colombia and those of other countries must be carefully considered. Many capital-exporting countries (in particular, the United States, the most important source of foreign investment in Colombia) allow foreign tax cre-

18. It may be worthwhile to emphasize that the case for uniform taxation of all income or consumption does not imply that a single rate should be imposed without regard to the economic position of the taxpayer, as indicated by his taxable income or consumption. A single rate does have important administrative advantages but it is generally agreed that these are outweighed by the vertical equity advantages of graduated rates.

19. Of course, this proposition is not necessarily true. Even though production efficiency is generally desirable, it is easy to imagine taxes that are not neutral which would nevertheless encourage saving, investment and work effort and lead to faster development. However, see note 23 below.

20. It should be noted that it is the consumption-based tax that is neutral. Whereas the income tax discourages saving, the consumption tax does not encourage saving; it is merely neutral.

21. This proposition need not be true. If, for example, investment incentives structured as deductions (rather than as credits) are sufficiently generous, high tax rates may reduce the cost of capital rather than increase it and may therefore provide greater incentives to investment. This is especially true for debt-financed investment where full deduction is allowed for nominal interest expense.

22. The aggregate domestic saving of an economy is comprised of private saving and public saving. Public saving is the excess of receipts over expenditures, i.e. the Budget surplus. Under a conceptually accurate capital Budget, the relevant surplus is that of receipts over current Government expenditures, with public investment spending being added to private investment. Funds available for investment consist of total domestic saving plus capital inflow from abroad.

23. This statement may seem almost heretic in a country that desperately needs economic development. However, to recognize its validity one need only contemplate the debt crisis faced by the countries which ignored it.

24. For example, assume that the before-tax real rate of return on a particular marginal investment is 10% and the after-tax return is 6%. The marginal effective tax rate is 40%. If the effective tax rate on another marginal investment with the same before-tax real rate of return is only 20%, resources will be allocated away from the former investment and into the latter. An even worse result occurs if the marginal effective tax rate is negative. Assume, for example, that tax incentives are so generous that the after-tax real rate of return is 12%, even though the before-tax return is only 10%. In such a case, the marginal effective tax rate would be minus 20%. The incentive for misallocating income in this case would be particularly strong.

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dits for income taxes paid to source countries. It might be a major mistake to introduce a change in Colombian tax law such as the SAT if such a change would jeopardize the foreign tax credit allowed by various home countries of foreign investors in Colombia.[25] If U.S. investors did not have access to this credit, they would be liable for both Colombian and U.S. income taxes on income earned in Colombia; such an outcome could make investment in Colombia unattractive.[26] By comparison, investment in Colombia by residents of countries which exempt income from foreign sources (under so-called territorial systems) might be adversely affected by an increase in the *level* of business taxation in Colombia, but be unaffected by a change in tax *structure* that collected the same amount of revenue from such investors. One important objective of the Report is to examine the importance of this issue, its possible resolution and ways to structure a consumption-based tax or augment it with withholding taxes in order to ensure continued collection of taxes on foreigners that would be creditable in their home countries.

G. Transition

Any changes in tax policy involve windfall gains and losses. For example, total or partial disallowance of deductions for interest expense such as those contained in Law 75 of 1986 would cause substantial windfall losses if applied to outstanding debt, and exclusion of interest income on existing obligations creates windfall gains. Similarly, changing the tax treatment of depreciable assets and inventories could also generate gains or losses. Such windfalls are generally unfair and they may cause undesirable economic disruptions, especially if they create financial hardship and the threat of widespread bankruptcy. Moreover, large windfall losses generate political opposition to tax reform that may be overwhelming even if matched by windfall gains realized by others. For these reasons, introduction of tax reform is frequently delayed or phased-in. For example, the inflation adjustments for interest income and expense introduced in the 1986 law (except for that on interest income of individuals) are to be phased in over a 10-year period. Even this has not stilled the complaints from taxpayers.

The difficulties of designing a satisfactory scheme for transition may be greater for some alternatives than for others. Thus transition to a consumption-based tax may be somewhat more difficult than transition to an inflation-adjusted income tax since the fundamental changes are greater. But, as indicated earlier, to some extent the difference is one of degree, rather in kind. The Report presents and evaluates proposals for a fair and orderly transition from the present tax system to both the inflation-adjusted income tax and the consumption-based SAT.

H. Consistency and conflicts

Some of the objectives just described are consistent but some are not. In the latter case it may be necessary to choose among competing objectives in designing a system for the taxation of income from business and capital.

Horizontal equity and economic neutrality are generally quite compatible since both require uniform and consistent taxation of all income (or all consumption). In a world without inflation both are generally consistent with simplification because non-uniform and inconsistent tax treatment of different types of income and expense is the source of much complexity, including complexity resulting from tax planning aimed to avoid taxes. In such a world the primary source of complexity under the income tax involves timing issues that must be resolved if income is to be measured accurately. Inflation adjustment, while necessary in an inflationary environment for a fair and neutral income tax, also introduces considerable complexity. By comparison, the SAT reduces complexity because it not only eliminates the need for inflation adjustment but most timing issues as well. However, calculation of the base for the net wealth tax (which the Report recommends should be retained regardless of whether income or consumption-based taxation is chosen) entails much of the complexity that would be eliminated by adoption of the SAT.

A consumption-based tax is simpler and more conducive to saving, investment and economic growth than is an income-based tax but it may not be acceptable on vertical equity grounds. Whether it would be eligible for foreign tax credits in capital-exporting countries is debatable but this may not be an important issue. These points are explained further in the next section.

IV. PRELIMINARY APPRAISAL OF ALTERNATIVES

During the recent debate on tax reform in the United States, the following was often used as a shorthand description of the proximate objective of income tax reform: "uniform and consistent taxation of all real economic income at low rates, without regard to the source or use of such income". Analysis of key components of this definition of a good income tax system, in light of the basic objectives set out in the previous section, is a useful starting point for the discussion of the reform of the taxation of business and capital income in Colombia. An analogous shorthand description of good tax policy could be applied to a consumption-based tax. Some, but not all, of the implications of attempting to implement this description of an ideal tax system suggest that a consumption-based tax may be preferable.

25. The basic issues under U.S. law are whether a tax system that allowed no deduction for interest expense would meet the test of being levied on "net income", whether immediate expending of capital goods would provide adequate compensation for the failure to allow interest deductions, and whether credit would be allowed for withholding tax on foreign remittances if credit for the SAT were denied.

26. This may overstate the situation somewhat, since countries that employ the residence principle generally do not tax the income of foreign subsidiaries until repatriated. After-tax income earned abroad is thus allowed to accumulate free of home-country taxes until repatriation.

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A. Taxing "all" income (or "all" consumption)

If horizontal equity is to be achieved, it is necessary – by definition – to tax "all" income (or "all" consumption, if that is the chosen measure of ability to pay). Similarly, economic neutrality requires uniform taxation of all income (or all consumption). Any deviations from uniform taxation will produce either horizontal inequities, economic distortions, or both.[27]

Whether the income tax or the SAT is preferable under this criterion depends in large part on whether annual or lifetime income is thought to be the better measure of taxpaying ability since the latter effectively exempts income from business and capital. A further consideration is whether there are sectors of the economy that are political "sacred cows" that cannot be fully taxed. If so, it may not be possible to achieve neutrality and horizontal equity under the income tax. It may, however, be possible to attain these objectives by adopting the SAT, which would lower the taxes on the other sectors to the level of taxes paid on real economic income in the favoured sectors.

B. Taxing "real" income

In a world of significant inflation it is necessary to allow for the effects of inflation in the measurement of taxable income. Otherwise, taxation will be neither fair nor neutral. Unfortunately, inflation adjustment introduces an undesirable increase in complexity into an income tax system. The situation, however, is not as bad as it might seem. An unindexed system generally provides numerous opportunities for tax-avoidance schemes that would not exist in an inflation-proof system. As a result of attempts to take advantages of these opportunities, economic relations, tax planning, compliance with the tax laws and tax administration are all the more complicated than in a system with no such opportunities. On balance, considering distortions of economic decision-making, as well as difficulties of understanding the law and complying with it, economic life under an inflation-proof system, once established, may not be much more complicated than under one that is not indexed and it may even be simpler.

One objective of the Report is to specify a system of inflation adjustment that reconciles (to the extent possible) the attractions of conceptual accuracy with simplicity of compliance and administration. Of course, no inflation adjustment is necessary under the SAT. However, if the net wealth tax is retained, many of the complexities of inflation adjustment that plague the income tax cannot be eliminated.

C. Taxing "economic" income

As indicated earlier, taxation of economic income requires that rules for the realization of income and the timing of deductions match economic reality as closely as possible. Perhaps the most visible timing issue involves depreciable assets; depreciation allowances for tax purposes should track economic depreciation as closely as possible. There are, however, many other issues of the timing of recognition of income and expense. Among the timing issues that must be addressed to achieve a conceptually accurate measure of taxable income are depletion, amortization, depreciation allowance, treatment of long-term contracts, instalment sales, original-issue discount bonds, pre-production expenses and methods of accounting (e.g. cash vs. accrual). Some of these issues may be so unimportant in a particular country that they could be ignored without significant loss of revenue, equity or economic neutrality. This is true to some extent even in Colombia where a significant problem is failure to comply with the tax laws (in particular by under-reporting of receipts) because of loopholes in the legislation regarding timing of recognition of income and expense. However, in certain sectors, such issues are important and should be addressed. In Colombia, for example, it would be desirable to consider tax treatment of pre-production expenses in agricultural industries (particularly the important cattle and coffee sectors), as well as provisions to improve the measurement of income in the advanced non-agricultural sectors. The administrative difficulties of handling these and other timing issues and the political problem of gaining acceptance of fair and neutral taxation of agriculture are important reasons to consider substitution of a consumption-based tax for income-based taxation.

D. Low tax rates

Avoiding high tax rates has several advantages. High income tax rates distort economic decision-making, discourage saving, investment and work effort, and encourage tax evasion.

High tax rates under a consumption-based tax do not discourage saving and investment. However, depending on the relative size of the 2 bases, it may be that tax rates can be slightly lower under the income-based tax than under the consumption-based tax. The difference in these potential tax bases may not be as great as sometimes assumed, however, since under the SAT interest income is in effect taxed at the company level through disallowance of interest deductions, rather than at the individual level, as under the income tax, where evasion is widespread.[28]

27. If economic behaviour were totally unresponsive to economic incentives, as reflected in prices and taxes, differences in tax treatment would only cause horizontal inequities. In fact distortions occur as behaviour adjusts to differences in taxation. Even so, adjustments often do not eliminate all inequities.

28. The problem of evasion of tax on interest income can be addressed by requiring withholding on interest payments, as under current law in Colombia. Since withholding rates generally cannot be closely related to the personal circumstances of the taxpayer, as reflected in his marginal tax rate, either under or over withholding is almost inevitable. If the withholding rate is set below the top marginal tax rate applied to individual income, evasion is likely to occur. If tax is withheld at the top marginal rate the result is likely to be nearly the same as under the SAT.

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E. Pros and cons of the SAT

As the above discussion indicates, taxation based on consumption has substantial simplification benefits relative to income-based taxation. Because it is based on cash flow, the business component of a consumption-based tax raises no issues of inflation adjustment or the timing of realization. The tax treatment of interest, i.e. no deduction and no taxation, is far simpler to administer than the treatment under a conventional income tax (deduction and taxation). Moreover, because it does not penalize saving, the consumption-based tax is more nearly neutral (at least with regard to the saving-consumption choice) and more conducive to saving and economic growth than is the income tax.

Several other factors must be considered in conjunction with these advantages. The primary objections to a shift to consumption-based tax involve concerns about vertical equity. A consumption-based tax is roughly equivalent to an income tax with an exemption for income from capital, i.e. to a tax only on labour income. Thus for a given set of tax rates a comprehensive consumption-based system is less progressive than an equally comprehensive income-based system. It may be possible to achieve the same distribution of tax burden across income classes under either system by utilizing a more progressive rate structure under a consumption-based system than under an income-based system. An alternative would be to use somewhat higher net wealth tax rates to augment the progressivity of the SAT. Either of these has costs in terms of disincentives, distortions and rewards for evasion. Moreover, in light of concerns of political acceptability and administration, there is a risk that, in practice, gifts, bequests and inheritances may not be effectively included in the donor's tax base and that the net wealth tax may, in fact, not be sufficiently progressive. As a result, the consumption-based system may in practice be less progressive than the income-based system.

Although compliance and administration would generally be easier under the SAT, this approach is not without difficulties. The possibilities of fraud in capital assets transactions and the problems of policing business deductions for expenditures which have a non-business component would be somewhat greater than under the income tax.

A further risk is that the United States or other capital-exporting countries might not allow a foreign tax credit for a consumption-based tax such as the SAT. If not, there is some chance that credit might also not be available for the withholding tax on foreign remittances. The Report suggests that both the SAT and the remittance tax accompanying it should be creditable. How the creditability issue would actually be settled in capital-exporting countries cannot be predicted with confidence. It should be recognized, however, that many U.S. corporations are expected to be in an excess foreign tax credit position; they will have paid more taxes to foreign Governments than can be taken as credits (in part because of recent changes in U.S. tax law which reduce tax rates and restrict the availability of such credits). For a U.S. firm in such a position there is little practical difference between creditable taxes and non-creditable taxes; in practice neither can be credited. As a result, whether a particular Colombian tax is creditable may have substantially less practical importance for the choice between the income tax and the SAT than is commonly assumed.

SRI LANKA:

Amendment to Imputation System

The imputation system introduced recently by Sri Lanka is described in an article by R.G.L. de Silva in the December 1988 issue of the *Bulletin*. The system requires a company resident in Sri Lanka to pay advance company tax (ACT) at the same time as it makes a qualifying distribution. Qualifying distributions are basically dividends paid out of profits subject to company income tax other than dividends received. A resident individual shareholder receiving a qualifying distribution is required to include in his statutory income both the distribution received and the ACT paid in respect of it. He may credit the ACT against the income tax payable on his assessable income and receive a refund of any excess over that income tax. Corporate shareholders do not include qualifying distributions in their income and receive no credit for the ACT.

It was the intention of the legislature that the ACT paid in respect of a qualifying distribution would "follow" the distribution through a chain of resident companies; a resident individual shareholder at the end of the chain would include in his statutory income, and receive a credit for, the ACT paid by the company at the beginning of the chain. Close scrutiny of the legislation reveals, however, that this is not the case.

Sec. 33A(1) of the Inland Revenue Act imposes the obligation on resident companies to pay ACT. It states:

> Every company resident in Sri Lanka shall be liable to pay for every year of assessment commencing on or after April 1, 1988, a tax (hereinafter referred to as the "advance company tax") ..... on an amount equal to the amount of every qualifying distribution made by that company during that year of assessment.

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Sec. 33B deals with individuals who receive qualifying distributions and states:

> (1) Where a resident person, other than a company, receives in any year of assessment, a dividend in relation to which advance company tax under subsection (1) of section 33A has been paid by any resident company, the statutory income of such person from such dividend for that year of assessment shall be deemed to be a sum equal to the aggregate of the gross dividend and the advance company tax which is attributable to such part of that dividend as consists of a qualifying distribution.
>
> (2) Every resident person, other than a company, whose total statutory income for any year of assessment includes a dividend in relation to which advance company tax under subsection (1) of section 33A has been paid by any resident company, shall be entitled to deduct from the tax payable by such person for that year of assessment, a sum equal to the advance company tax paid on such part of that dividend as consists of a qualifying distribution. Where the amount to be so deducted exceeds the tax payable by him for that year of assessment, the excess shall, subject to the provisions of Chapter XXIII, be refunded to such person.

The problem is that Sec. 33B deals only with dividends which are qualifying distributions and is silent with respect to dividends paid out of dividends received from other companies. The result is that an individual shareholder who receives dividends which have been channelled through one or more intermediate companies since they were first distributed has no right to a credit for the ACT paid in respect of the first distribution, nor is he obliged to include the ACT in his statutory income. No other provision of the law deals with this situation, so that there is a gap in the legislation.

Having discovered the problem with the legislation, the International Bureau of Fiscal Documentation consulted Mr. de Silva, who is the Sri Lanka correspondent for the *Bulletin*. Mr. de Silva, agreeing with the IBFD's interpretation, referred the matter to the Commisioner of Inland Revenue (Corporate Taxes). The Commissioner has said that the necessary amendments to the law will be made and that in the meantime the position will be rectified administratively.

The following example sets out the way in which the imputation system is intended to work. Assume that all persons in this example are resident in Sri Lanka and that both companies are taxable in respect of profits at the rate of 50%.

Company 1	
Profit	200
Pays dividend to Company 2	100
Withholding	20
Net dividend	80
Company tax	100
Advance company tax	50
Still to pay	50

Company 2

	Profit	Dividend received	Total
Profit	300		300
Received dividend from Company 1		80	80
Total income			380
Pays dividend to individual	100	40	140
Withholding	20	NIL	20
Net dividend	80	40	120
Company tax	150	NIL	150
Advance company tax	50	NIL	50
Still to pay	100	NIL	100

Individual

	Paid out of profit	Paid out of dividend	Total
Net dividend received from Company 2	80	40	120
Withholding	20	NIL	20
Grossing up	NIL	10	10
Advance company tax	50	25	75
Total income	150	75	225
Withholding credit	20	NIL	20
Grossing up credit	NIL	10	10
Credit for advance company tax	50	25	75
Total credit	70	35	105

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INTERNATIONAL:

Achieving Compliance in Developing Countries

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I. INTRODUCTION

It is difficult for tax administrations in developed countries to achieve acceptable levels of compliance with income tax laws so tax administrations in developing countries should not feel badly if they are not achieving high levels of compliance with their tax laws. Tax administrations in developed countries such as the United States have access to all the modern technology, yet only obtain voluntary compliance levels in the order of 80%.[1] This does not mean that tax administrations in developing countries should think that it is impossible for them to achieve high levels of voluntary compliance. By learning from experiences in developed countries and by knowing more about their own taxpayers they can improve their voluntary compliance rates.

The quantity and quality of resources required by tax administrations are to a large extent determined by the type of tax system which is introduced. Legislatures can help by recognizing this and then giving their tax administrators a manageable tax system and the resources needed to administer it. Compliance is both an administrative and legislative matter. Tax goals such as equity are not achieved by designing a tax system which is fair. Any fair system which is not administered as planned becomes inequitable. Noncompliance also produces inequities. In some situations it might be better to design a slightly less sophisticated tax system. On its face it might appear less equitable than another system but because it is administratively simpler it may result in greater equity.

The purpose of this article is to review those aspects of a tax system which affect compliance, over which legislators or administrators have some control. This article concentrates on income tax which means that caveats such as those given by Mansfield are pertinent. He noted that, in developing countries, income tax was generally less important than other taxes and levies, including taxes on foreign trade, excises on beverages, tobacco, or fuel, and sales taxes.[2] The article does not address all issues and specifically excludes from consideration matters dealing with income from illegal activities[3], international transactions[4], exchange of information provisions and anti-avoidance provisions.

II. GENERAL PRINCIPLES

Developing countries differ markedly in terms of the type of tax systems that can be implemented. At least the following impinges on the type of system which can be adopted; the political system and ideology, the role expected of Government in implementing social and economic policies, the extent to which Government intervention is tolerated, the type of tax system which the country has had, the extent of the agricultural base, the level of literacy, the proportion of the population at or below subsistence level, the degree of concentration of population and of industry, the extent of endowment of natural resources, the balance of payments position, the level of national debt, the rate of inflation, the rate of economic growth, etc. So many things affect the tax structure that it is not possible to prescribe any one system for all countries.

Tax systems are, to an extent, fashioned by the circumstances into which they will be put and the tax scenarios which have gone before. What is possible and what is not possible change as circumstances change. For instance, self-assessment is inconceivable if literacy is low but as literacy levels rise so does the prospect of self-assessment being successful. Tax reform is likely to be a continually evolving process. Any changes made should not be presumed to be the last changes required. On the other hand, when a legislature approaches the process of tax reform it should not think that it must achieve all the desired changes at one time. In fact, the fewer the changes and the less significant they are the more likely they will succeed. Tax reform in smaller doses is both more politically possible and more administratively feasible.

Legislators should not expect too much of their tax systems nor should they try to use their tax systems to accomplish too much. Tax systems in developed coun-

1. *Tax Administration: IRS' Tax Gap Studies,* GAO/GGD-88-66-BR (March 1988) Washington at 23.
2. C.Y. Mansfield, *Tax Administration in Developing Countries: An Economic Perspective,* International Monetary Fund Working Paper, 87/42, Washington (1987).
3. It is arguable that non-reporting of income from illegal activities is independent of tax policy and tax administration. For further discussion on this topic, see S. Rochupan, "Determinants of Income Tax Evasion: Role of Tax Rates, Scope of Tax Schedules, and Other Factors", in *Supply-Side Tax Policy: Its Relevance To Developing Countries,* V.P. Gandhi, International Monetary Fund, Washington (1987) in particular at 158-159.
4. For this topic readers could consult C.R. Irish, "Transfer Pricing Abuses and Less Developed Countries", *Asian Pacific Tax and Investment Research Centre Bulletin,* Part I (June 1987) at 227-236; Part II (July 1987) at 298-313.

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tries have been very efficient in raising revenue (e.g. in the United States it costs less than half a cent to collect each dollar of tax).[5] Consequently, those systems have been asked to do many things other than raise revenue. This makes tax laws very complex and it can lead to problems. For instance, use of the Internal Revenue Code (IRC) in the United States to encourage certain types of investment resulted in abuse of tax shelter provisions. This problem was addressed in 1986 with substantial withdrawal of these provisions. Legislatures should, therefore, not always assume that the only way to implement policy is through the tax system. It is possible that direct grants may be a better method of subsidy than are tax rebates/credits/deductions. Direct grants are also more likely to limit the total cost of implementing the policy. If policies are introduced via the tax system it is useful to consider doing so in conjunction with a "sunset clause".[6] This requires specific Government action to allow those policies to continue.

Too much reliance should not be placed on any one type of tax. Government spending always seems to increase over time. It does not seem to be flexible downwards. If there is too much reliance on one type of tax, tax rates rise. The extent of the rise depends on several factors but is exacerbated if the tax base is narrow. One of the consequences of higher tax rates is the effect they have on compliance. Higher tax rates generally mean reduced compliance or at least reduced incentive to comply.[7]

Particular problems can be encountered where Governments, too heavily, rely on product-based taxes. For instance, if a Government depended on an excise on oil it would encounter severe problems if oil production fell sharply or if demand for oil suddenly dropped. In some instances these problems might be temporary but in others they might be more permanent.

On the other hand, Governments should not rely on too many different types of taxes. Each tax requires a set of laws as well as a structure to administer and collect it. A greater number of taxes therefore implies more laws and greater administrative structure. Lawmaking facilities and administrative resources are always at a premium and are more likely to be at a greater premium in developing countries.

Tanzi argues that where tax systems are concentrated around a few taxes it is easier to access the impact of policy changes and explain the effects of such changes to policy makers, legislators and the public.[8] Further, where there is a greater variety of taxes it is likely that some taxes will produce little revenue in relation to the resources required to collect them. Governments in developing countries might therefore be advised to use resources to collect fewer types of taxes which have well-defined but wide bases. As administrative resources grow or as they become more sophisticated, attempts can be made to collect a greater variety of taxes.

Often in developing countries the tax base and sometimes the taxpaying community for a particular tax is very concentrated. Banking is an example.[9] It is usually concentrated in major cities, profitable and efficiently organized and therefore is a prime target for taxation. It has a narrow base and does not require a great deal of a revenue authority's resources to collect or administer. Unless care is taken taxpayers can be treated inequitably by the tax system and the economy of the developing country may suffer. For instance, as taxes on banking transactions rise, banking firms have an incentive to either switch part of their investment to non-banking activities or to move some or all of their banking activities offshore. There would also be an incentive to evade or avoid tax. The end result is that efforts are not put into activities which are most productive. The tax system should therefore aim to make the tax base as wide as possible, to ensure that all to whom the tax is directed are taxed and to keep tax rates as low as possible.[10]

What follows is a list of specific guidelines which emphasize compliance activities. It is not essential that all these guidelines be followed. In some cases pursuit of other goals might mean that they be disregarded. The point of the guidelines is that where there is no other specific goal which has to be followed, there is a preferred way of doing things if compliance is to be achieved.

III. SPECIFIC ISSUES

A. Identification of the taxpayer

Perhaps one of the most important initial administrative tasks is that of identifying all potential taxpayers. Similar tasks of identification exist where there are withholding agents or where there are information reporting agents. None of these tasks is easy. However, each taxpayer, each withholding agent and each information reporting agent must be uniquely identified. When used with taxpayers' names, identification numbers (ID numbers) can be used as a cross-check to minimize errors in all aspects of administration of taxpayers' tax returns, especially:

- identifying whether taxpayers have lodged returns;
- determining whether taxpayers are entitled to cre-

5. See Table 22 of Department of Treasury, *Internal Revenue Service Highlights of 1986*, Publication No. 1265 (Rev 7-87).
6. A "sunset clause" is one which terminates the operation of the provision at a particular date. The investment allowance provisions introduced in Australia applied in respect of plants installed between 1 January 1976 and 1 January 1988. See Sec. 82AA-AQ of the Australian *Income Tax Assessment Act* 1936, as amended.
7. Compliance could improve if there is reduced opportunity or if special circumstances existed. However, in the absence of these factors and based on the author's own research in Australia (see footnote 29), tax rates may be one of the key elements influencing the level of evasion.
8. V. Tanzi, "Tax System and Policy Objectives in Developing Countries: General Principles and Diagnostic Tests", 3 *Tax Administration Review* (January 1987) at 23, 24.
9. Other examples include importers, oil producers and mining operations.
10. However, note Richupan's comment that further "studies are needed before making a definitive conclusion regarding the effect of the tax rate on tax evasion". In S. Richupan, "Determinants of Tax Evasion", op. cit. footnote 3 at 162.

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dits for tax instalments which have been deducted;
- checking claims relating to dependants; and
- using information contained in information reports.

In relation to taxpayers there are 2 basic approaches. The first is to try to allocate numbers to everyone. A second approach is to allocate numbers only to those who are likely to be liable for tax. Pavesi and Wencelblat report that Argentina tried the former approach and that it "resulted in a massive number of taxpayers and information which the tax administration was not able to handle".[11] Therefore it might be better to allocate ID numbers to those who are likely to be liable for tax. This places less stress on tax administrations. It also saves a number of classes of persons, such as the elderly, from having to correspond with the tax administration. One difficulty with this approach is that of identifying those to whom ID numbers should be allocated. In developed countries this is primarily achieved through voluntary compliance. This means that checks are required to determine whether all who should have ID numbers do in fact have them. A number of types of checks can be developed, most of which involve checking information reports or data bases held by other agencies. Examples include electoral rolls, social security registers, health department registers, customer listings of electricity, gas and water authorities, real estate registers, records of agencies that issue licences, applications to import certain types of goods (e.g. luxury goods), membership lists of professional bodies, lists of employer groups, etc. These lists will contain the names of persons not liable for tax as well as those liable for tax. Some lists (e.g. electoral rolls) will be less useful than others (e.g. lists of members of professional associations). The best sources are those which reflect income or wealth of individuals. Experience will enable refinements to be made. To this end it will be helpful if details of each enquiry are recorded. Subsequent analysis will then permit selection criteria to be improved. If background characteristics of non-filers are also recorded, profiles can be developed which can be incorporated into predictive models.

Apart from Japan, which has yet to implement a tax file number, developed countries have file number systems and there is no reason to expect that developing countries have serious problems in this regard should they seek to introduce tax file numbers. Whichever approach to issuing tax file numbers is adopted, the key to success is to continually update and monitor the system which is used.

Often a significant problem is ensuring that current addresses are available for taxpayers. Where taxpayers do not volunteer new addresses the tax administration will have to make some effort to establish those addresses. Experience in the United States suggest that current addresses can be obtained by:
- visiting the taxpayer's last known address and checking with the current residents or neighbours;
- checking with the taxpayer's last known employer;
- checking telephone directories; and
- checking subsequent returns lodged by the taxpayer or by third parties.[12]

Care must also be taken to ensure that any one taxpayer is not issued more than one number. Even sophisticated tax systems issue multiple ID numbers for some taxpayers.[13] Sometimes this is caused by computerization. The United States Internal Revenue Service (IRS) has issued a second employer identification number where the employer's name has been expressed as one word, for instance as "JohnDoe", when the same name on the master file was correctly shown as 2 words, i.e. as "John Doe".[14] The goal for developing countries remains the same even though no developed country has perfected a system of ID numbers. Early failures and imperfections in the quest for a comprehensive ID system must be expected and tolerated. What cannot be tolerated is the attitude that because there will be problems with the ID system it should not be implemented.

While the process of perfecting a file number system will be an ongoing one, there are some measures which can be undertaken to encourage taxpayers to obtain ID numbers (or at least discourage them from not having one). The "back-up" withholding tax system, adopted in the United States in 1982 for interest income, is an example.[15] Under this system where taxpayers cannot quote a tax file number to the institution holding their money, tax must be withheld. Similarly, in Australia a higher rate of withholding applies in respect of "prescribed payments"[16] where a payee cannot supply the payor with a tax file number.

Australia has also amended its legislation to penalize taxpayers who do not have tax file numbers. Individuals who cannot quote a tax file number are subject to higher pay-as-you-earn tax instalments on any wages, unemployment benefits or sickness benefits they receive. After 1 July 1991, tax file numbers will also be required by most taxpayers to open a bank account or an account with a building society or credit union, to make certain investments in Government or semi-Government securities, to invest through solicitors trust funds, to purchase shares in public companies and to make investments in cash management trusts or in property trusts.

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11. P.F. Pavesi and H.B. Wencelblat, "The Future of Important Functions in Tax Administration: Collection", *The Challenge of Tax Administration Until the End of the 20th Century: Technical Papers and Reports of the 15th General Assembly of the Inter-American Center of Tax Administrators,* International Bureau of Fiscal Documentation, Amsterdam (1984) at 10.
12. General Accounting Office, "Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them and Collect Their Taxes", GGD-79-69, General Accounting Office (Washington 1979) at 34.
13. See the report of the General Accounting Office GAO/GGD-88-77 *Tax Administration: IRS Could Reduce the Number of Unproductive Business Non-Filer Investigations,* U.S. General Accounting Office, Washington (May 1988).
14. Ibid. at 15.
15. Introduced by the Interest and Dividend Tax Compliance Act of 1983, and subsequent Regulations.
16. "Prescribed payments" are, in essence, intra-industry payments for services supplied in the building industry, the motor vehicle repair industry, the road transport industry and the cleaning industry.

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Sometimes taxpayers are reluctant to come forward and sign up for an income tax ID number because they have tax returns outstanding. If this is a particular problem in developing countries the legislature might consider the merits of having a brief tax amnesty prior to fully implementing a tax file number system. Under a tax amnesty, taxpayers would be required to lodge delinquent tax returns but they could be exempt from penalties for late lodgement. Australia offered taxpayers a 5-month amnesty in 1988. Taxpayers had to pay any taxes owed but were only required to lodge up to 5 years' returns. If their returns were correct they were not liable for non-lodgement or late payment penalties. This amnesty was a great success in terms of the number of new tax filers it produced. Prior to the amnesty it was estimated that there were over 360,000 non-filers.[17] During the amnesty period some 275,000 or 75% of these non-filers lodged returns. Almost 71,000 had never lodged a return or had not done so for many years.[18] The Australian amnesty was offered as a once in a lifetime opportunity. Amnesties will not always be successful, especially those which are offered, or are expected to be offered, more than once.[19]

B. Tax legislation and the tax base

The tax base should be clearly defined. In this regard, Surrey's 1964 suggestion that "before a country considers how best to administer its tax system it must possess a clear picture of the scope of its tax system"[20] remains relevant. Care should be taken not to lift words and phrases from countries' legislation. Those words and phrases might have one meaning in the country from which they came but another in the country in which they are to be applied. There is no substitute for using skilled local draftsmen. If possible they should have experience in drafting income tax laws. In this respect there is one feature of Australian taxation administration which might be of interest to lawmakers in developing countries. The Australian Taxation Office now has a law improvement unit which develops options for simplifying new and existing legislation. It also reviews existing legislation to identify redundant provisions. Establishment of such a unit within the tax administration of developing countries could prove worthwhile. It would lead to a concentration of technical staff with this type of talent and would recognize the importance of keeping tax laws simple.

When defining words and phrases it should be recognized that there are always at least 2 approaches. Simple definitions can be used or complex definitions can be used. Both approaches can provide opportunities for circumvention or avoidance. Simple definitions cannot always provide for complex business situations. On the other hand, complex definitions may, in defining the circumstances in which something is taxable, implicitly or explicitly also define the circumstances in which it is not taxable. Tax administrations will be aided if they, like the IRS in the United States, are given authority to make binding regulations.[21] Alternatively, it might be helpful if there is a provision similar to Sec. 15 AB of the Australian *Acts Interpretation* Act (1901). This provision allows judicial bodies in interpreting Commonwealth legislation to take account of certain extrinsic material produced at the time the legislation was enacted. This would include parliamentary speeches outlining the purpose of the legislation and explanatory material accompanying the legislation.

Simple definitions are, however, likely to be easier to administer. For instance, consider how the term "resident" ought to be defined. It can be defined in terms of physical presence (e.g. an individual is a resident if that person is in the country for more than 183 days during the year of income). On the other hand, it can be defined in terms of domicile or habitual place of abode. If it is defined in these latter ways, there is greater scope for taxpayers to manoeuvre as these options are not objectively determined.

Policymakers in developing countries can help by keeping the base as simple as possible. However, experience in developed countries shows that over time and particularly as the nature of business transactions becomes more complex so do the tax laws.[22] There are other policy matters which the legislature can keep in mind which may help to control the length of the tax statute. For instance, when considering matters such as depreciation provisions one might consider basing depreciation on the effective life of the plant or by having a standardized life. The latter may be less equitable and may not reflect economic reality but it will result in simpler tax laws and probably less abuse. Similarly, provisions relating to valuation of stock, deductions for repairs and deductions for bad debts can be defined to aid compliance. For example, if taxpayers, in valuing trading stock can use "cost" it would be useful to define this to include all those costs which have been reasonably necessary to get the stock to its existing location and to its existing condition. Failure to do this will provide taxpayers with the opportunity to use something less than full cost, the result being that taxable income will be understated. Where there is doubt whether any particular provisions can achieve its intended purpose, anti-avoidance clauses can be added.[23]

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17. *Commissioner of Taxation, Annual Report 1987-88,* Australian Government Publishing Service, Canberra (November 1988) at 12-13.
18. CCH (Australia) Ltd., *Tax Week,* No. 729,24 (October 1988) at 5.
19. See the report of the Spanish experience of the early 1980s cited in M.C. Amoros, "Improvement and Simplification of the Legal System" in *Measures for Improving the Level of Voluntary Compliance with Tax Obligations,* International Bureau of Fiscal Documentation, Amsterdam (1985) at 54.
20. S.S. Surrey, "Tax Administration in Developing Countries" in *Readings on Taxation in Developing Countries,* R. Bird and O. Oldman, Third Edition, The Johns Hopkins University Press, Baltimore (1975) at 482.
21. Local history may be important in this regard. In some countries, administrative history may suggest that such discretion might work well. However, in other countries such discretion might be abused and might be a source of corruption. If the latter is the case, administrative discretion should probably be avoided. Care should also be taken to avoid the issue of too many regulations as this can make the tax system too complicated.
22. In Australia, in 1988, the Income Tax Assessment Act 1936, as amended, exceeded one million words in length.
23. Often anti-avoidance provisions may take the form of an administrative discretion such as "...but in any event the amount of the deduction

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The number of tax exemptions should be kept to a minimum as should the number of tax credits, rebates and deductions. Policymakers in developing countries should question whether it is essential to provide tax relief for such things as expenditure on education, medical care, housing and charity. As the number of these items grows not only do tax laws become more complex but they also provide avoidance opportunities to some taxpayers. Legislation remedying the defects can be overly complex and can give scope for further avoidance opportunities. A never-ending cycle can begin so simply. This cycle may be avoided by not offering the exemption, rebate, credit or deduction in the first place. This does not mean that those activities not be supported. It simply means that they not be supported through the tax system.

Another way that care in designing the tax system can keep tax laws simple is to ensure that different business structures are treated equally, i.e. that the tax system is neutral towards sole traders, partnerships, trusts and companies. To the extent there are differences in the amount of tax paid by different business structures there will be incentives for taxpayers to alter their structures. Often when revenue authorities see taxpayers altering their business structures to pay a lesser amount of tax they react in one of 2 ways. Either they assess the taxpayer as though the taxpayer had not made the change or they persuade the legislature to amend the tax laws to limit the tax advantages sought. This either means that there will be more disputes between taxpayers and revenue authorities or that the tax laws become more complex. The real cause, i.e. lack of neutrality, is often forgotten. Neutrality is a matter to be taken into account when both tax base and tax rates are being considered.

Where possible the tax base should be able to be objectively determined. Unfortunately, developed countries do not provide enlightened examples of this. For instance, revenue codes in the United States and Australia both set out to tax[24] yet neither provide an exhaustive definition of the term "income". This may have been intentional but in the case of Australia where, until 19 September 1985, capital gains were not part of assessable income, taxpayers were given an incentive to look for ways to characterize amounts as non-taxable capital gains. What seems preferable is to tax both income and capital gains and to include a comprehensive definition (though not necessarily an exhaustive definition) of both income and capital gains. Again it may assist if regulations can be made. These can explain terms such as "income" in particular situations which previously have not been resolved. Such regulations also have the advantages of more immediate promulgation.

C. The tax unit

Generally, tax systems start out by taxing individuals per se and by taxing entities. In some countries where there has been a progressive rate scale this has motivated taxpayers to split income with other family members. In response, legislation broadened the definition of the tax unit to include members of the taxpayer's immediate family or to include all household members. Where the tax unit remained the individual, other legislative responses to income splitting have led to complexity of the tax laws. Perhaps the only way to preserve the rights of individuals to be taxed and to prevent tax laws from becoming unnecessarily complex is to make sure that there are few incentives for taxpayers to split income. One way this can be achieved is by keeping tax rates lower and flatter. To an extent this may impinge upon equity considerations but that may have to be the nature of the choice that has to be made.[25]

D. Tax rates

According to Oldman and Bird, "the prevalent form of income tax in much of Latin America, as in Francophone Africa, is probably still the "mixed" system (schedular taxes capped by a complementary global tax)...".[26] While there may be some justification for a schedular approach, the goal should be to work toward a global tax with all income subject to the same rate scale. Failure to do this is inequitable. It discriminates against the more heavily taxed income and provides incentives to recharacterize that income into a form which suffers less tax.

Previously, it was argued that steeply progressive tax rates encouraged taxpayers to split income with others and that one way of avoiding this was to have lower and flatter tax rates. Experience in developed countries in recent years has shown a move towards lower flatter taxes. For instance, the *Tax Reform Act 1986* in the United States reduced the maximum marginal rate of tax for individuals from 50% to 28%. It also reduced the maximum corporate rate from 46% to 34%. Developing countries might also be wise to concentrate on broadening their tax base and imposing taxes at lower, flatter rates. This may, as in the case of the United States, result in larger rather than smaller income tax collection.[27]

There are other aspects of tax rates which must be considered. First, the rates of tax applicable to ordinary income and the effective rates applicable to capital gains must be considered. Where these rates differ they generally favour capital gains. This will encourage taxpayers to characterize receipts as capital gains,

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shall not exceed the amount, which in the circumstances the Commissioner considers to be reasonable". However, see the discussion in footnote 21 about administrative discretion.

24. See Sec. 61 of the IRC and Sec. 25 of the Australian Act.

25. If equity is essential there are other ways, apart from the income tax rate scale, that can be used to try to achieve the desired result. For instance, a flat rate income tax might be coupled with a wealth tax or with a tax on luxury goods. Alternatively, subsidies could be used to restore equity to those groups which are considered to be adversely affected by a flat rate income tax.

26. O. Oldman and R. Bird, "The Transition to a Global Income Tax: A Comparative Analysis", 31 *Bulletin for International Fiscal Documentation* 10 (1977) at 439.

27. See *Tax Notes* (12 December 1988) at 1150, which reported an increase in the average effective rate of tax, for the top 1,000 U.S. corporations, from 14.9% in 1986 to 24.7% in 1987.

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which are taxed at a lower effective rate. The response to this problem in the United States was to tax capital gains as ordinary income but to reduce, sharply, the rate of tax on ordinary income.

Another problem and one which is likely to be important in developing countries is that of freeing from tax what is regarded as subsistence income. This can be achieved in several ways. First, the rate scale can become operative only after taxable income exceeds a certain level. Second, taxpayers can be permitted to take deductions for personal allowances. Alternatively, some combination of exemptions and personal allowances might be used. All of these reduce the amount of taxable income and thus final tax payable. This issue is more significant in developing countries because a greater proportion of the population will earn only subsistence income.

However, the higher the exemption level, the fewer the number of taxpayers. While this provides the opportunity for the tax system to be more efficient it can also provide opportunity for avoidance through income splitting. In addition, as the number of taxpayers falls, the rate of tax which must be imposed to collect a given amount of revenue rises. The higher the rates of tax the greater the incentive to evade or avoid taxes. If income taxes are to be kept low, greater emphasis must be placed on indirect taxes but these are regressive in nature. The choice of the tax-free threshold, and/or the choice of the size of the personal allowance is therefore critical.

E. Penalties

According to Smith and Kinsey, "for sanctions to be an effective threat and deterrent against non-compliance, taxpayers must (1) know about them, (2) believe that the sanctions apply to them and (3) accept that they are legitimate".[28] Just taking the first of these factors, tax administrations in developing countries could ask themselves what steps are being taken to ensure that taxpayers are aware of the penalties for tax evasion. For instance, how are the penalties publicized? At what point of the tax year are penalties brought to taxpayers' attention? One simple and timely way of making taxpayers aware of penalties is to have some sort of statement on the tax forms they have to complete each year. Taxpayers could be reminded of the maximum penalties that can be imposed for various offences. It might also help if some details of previous enforcement activities were also included. All communications should be in plain language.

Penalty systems often develop over time. This may mean they lack coherency and communality of purpose. To be effective against non-compliance, penalties must form a coherent set and must act as a deterrent. Penalties do not act as deterrents if they are imposed at low rates or if taxpayers are unaware of them. This presents particular problems for developing countries which often have low literacy rates. The power of the mass media should not be overlooked. Even illiterate and semi-literate people listen to radio and watch television. One Australian study indicates that increased knowledge of penalties can reduce taxpayers' desire to evade tax.[29]

One mechanism for imposing penalties which should be avoided is that of expressing penalty provisions in terms of fixed amounts of currency. Even where those penalties are initially effective they lose their real significance over time because of inflation. It seems preferable to express penalties as percentages of the tax sought to be evaded.

There should also be an additional penalty for late payment and this penalty should not be allowed to fall below the rate of inflation. One way of doing this is to express the late payment penalty in terms of a market rate of interest, e.g. x% above the short-term bond (or some equivalent) rate.

F. Collection

Experience in developed countries suggests that there are at least 2 general principles in relation to collection of tax. First, the bulk of the tax that will become payable should be paid during the year in which the income is derived. Second, where possible tax should be collected at source. There are, as Yudkin suggests, several advantages to this. "It assists compliance, avoids the problem of a taxpayer's inability to pay, reduces the number of tax payments to be processed, puts the revenue into the treasury faster, identifies taxpayers, and makes taxes psychologically easier to bear."[30]

In the United States, the effect of collection at source on compliance has been significant, as the following data shows.

Table 1

Compliance rates for different classes of income for the United States 1981

Wages and salaries	94%
Interest	86%
Capital gains	58%
Informal supplier income	20%

Source: *Income Tax Compliance Research: Estimates for 1973-81*, Internal Revenue Service, U.S. Government Publishing Service, Washington (July 1983) Table III.

Table 1 shows that compliance is highest for wages and salaries. This class of income is subject to tax instalments at source. The next highest compliance is for interest. This class of income is generally not subject to deduction at source although it is subject to informa-

28. K.W. Smith and K.A. Kinsey, "Cooperation and Control: Strategies and Tactics for Tax Examination" 2 *Tax Administration Review* at 26-7.
29. See I.G. Wallschutzsky, *The Effects of Tax Reform on Tax Evasion*, Australian Tax Research Foundation, Research Study No. 8, Sydney (1988) at 35.
30. L. Yudkin, *A Legal Structure for Effective Income Tax Administration*, International Tax Program, Harvard Law School, Cambridge (1971) at 32.

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tion reports by third parties. While some capital gains are also subject to information reports, these reports are at present not always matched with information on taxpayers' returns. Compliance therefore is more likely to be affected by deduction at source or matched information reporting.

Tax collection practices in developed countries show that, with varying degrees of efficiency, tax can be collected at source in respect of a wide variety of types of income including:

- wages and salaries;
- pensions and annuities;
- lump-sum retirement payments;
- interest income;
- dividend income;
- professional fees;
- prizes (where these are taxable);
- payments to entertainers, athletes and actors;
- film royalties;
- rent on real property;
- royalties; and
- insurance commissions.

In time, tax administrations in developing countries also should be able to collect tax at source for most of these types of income. If they have not already done so they could start with wages and salaries and with those types of income which have few paying agents. Interest income, public company dividends and royalties are likely possibilities.

Australia has had success in collecting tax from various "hard to tax" groups though the prescribed payments system. This system applies in respect of intra-industry payments in the building industry, the cleaning industry, the road transport industry and the motor vehicle repair industry. The system collects tax at a standard rate of 15% (20% from 1 July 1989) of the gross payments made. A higher rate applies where taxpayers do not quote a tax file number.

Tax collection is simpler where standard rates are used and where rates are applied to gross income. Tax collection will be more accurate where there is a small difference between gross income and taxable income. On the other hand, filing of annual returns is aided if collection practices over-withhold. Taxpayers look forward to their assessments as those assessments mean refunds of tax.

Developing countries can face problems when they introduce a "Pay-As-You-Earn" system where previously they had a payment in arrears system. The main problem is the possibility of taxpayers having to pay 2 years tax liability in the transition year. Developed countries have faced these problems and a number of options for overcoming the problems are given by Yudkin.[31]

Developing countries might also have to guard against non-payment by the withholding agent, of tax deducted at source. This can be done by instituting strict administrative controls and/or by harsh penalties. These penalties are usually levied against the employer. However, in the United States Sec. 6672 of the IRC permits the penalty to be imposed against the "responsible person" who failed to remit the tax. Some developed countries (e.g. Australia) prescribe prison sentences, as well as pecuniary penalties, for these types of offences.[32] Such penalties are rarely used but can be justified because non-payment of taxes withheld is tantamount to embezzlement or fraud.

Penalties will only be effective if offences are detected and if penalties are imposed. One of the biggest problems with withholding systems for wages and salaries is the "misclassification" of workers as subcontractors when they should be classified as employees.[33] What is helpful is a definitive statement of what constitutes "salary or wages". In Australia, Sec. 221 (1A) goes to some length to define the term "salary or wages" and this is supported by various rulings which either relate to particular problem areas such as company directors (see IT 2128) or authors (see IT 2009) or they relate to matters of principle (see IT 2129).[34]

Prompt payment of taxes withheld must also be required. Otherwise as employers get into financial difficulties they will be tempted to use the funds to solve their liquidity problems. Where inflation is a problem, unless funds are regularly remitted, the Government will be losing some command over real resources. Two types of penalties can be imposed in Australia, i.e. a culpability penalty for failing to do what was required and a late penalty for failing to do what was required in a timely way. The first penalty is 20% of the unpaid tax and the second is 20% per annum of the unpaid amount plus the amount of the first penalty. The per annum penalty is calculated from the time tax should have been paid up to the time it is paid.

G. Returns and assessments

1. Returns by taxpayers

Often in developing countries a large proportion of the population lives outside the money economy. Where this occurs it is not feasible to try to tax them. For those who are required to file, return forms should be easy to obtain and easy to complete. The language should not be overly technical and explanatory guides should be readily available. Filing requirements are perhaps best couched in terms of gross income.

It might also help if taxpayers can be assured of complete confidentiality with information they disclose in their tax returns. This is particularly important in those

31. See L. Yudkin, *A Legal Structure for Effective Income Tax Administration,* op. cit., at 40-1.
32. The relevant sections of the Australian legislation are Secs. 221 F(14) and G(5). The maximum penalty for failure to remit taxes withheld is A$ 5,000 or 12 months' imprisonment, or both.
33. See *IRS Fact Sheet,* U.S. Department of the Treasury, FS-88-3 at 3.
34. The primary test in IT 2129 is the "control" test. Under this test, a decision is made on whether a person is an employee by looking at how the work is to be done, where the work is to be done, when the work is to be done and who is to do it. IT 2129 lists some 23 questions which are indicia of employment. A simpler approach might be to ask what percentage of a payment is for labour. If it is greater than a set percentage (e.g. 50%), the payment is treated as being for wages or salary.

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economies which are highly regulated. Taxpayers may have broken regulations, relating to such things as pricing, production or exchange control, and may be reluctant to declare resultant income if their transgressions are reported to others by the tax authorities. Strictly enforced secrecy provisions are required so that taxpayers are not discouraged from lodging returns.

Taxpayers should be required to sign some sort of declaration concerning the correctness and completeness of the information contained in the return. All returns should have to be lodged within a clearly defined period of time (2-4 months is common in developed countries) and should contain sufficient information to identify the taxpayers (e.g. ID numbers, date of birth, address, occupation, name of spouse, etc.).

Penniman argues that "putting as many items as possible in question form will press on taxpayers' memory and conscience. Administrators report that although many taxpayers may find it easy not to tell the whole truth when the return does not demand it, few are willing to put a clear falsehood in writing in answer to a specific question".[35] Australia now uses a simplified question and answer type format for wage and salary earners (Form S). This did, however, result in a lengthier tax form having to be completed. The extent to which return forms can be simplified in this way depends to a large extent on the simplicity or complexity of the tax laws.

Some developed countries even have videos available to help taxpayers understand tax laws and filing requirements.[36] While this might be beyond the immediate realm of possibility for developing countries it ought to be kept in mind as an example of the ways taxpayers can be made aware of their responsibilities. The underlying objective should be to have taxpayers, or their agents, do as much as possible. This will facilitate the transition to self-assessment, which should be a long-term goal.[37]

2. Assessments

Generally in developed countries assessments are based on information contained in taxpayers' returns. However, this may not always be possible in developing countries either because the returns do not reflect the information contained in the taxpayers' books or because the taxpayers' books were non-existent or unreliable. Where information in taxpayers' returns cannot be used some basis of estimation must be used. Musgrave suggested that for Bolivia consideration should be given to a presumptive tax for taxpayers with less than 3 employees or an estimated tax for larger taxpayers. The presumptive tax would have imputed income to taxpayers based on some assumed predictive factor. The estimated tax calculates tax by grossing up income figures reported by taxpayers.[38] As Bird notes, systematic use of standard assessment techniques "probably offers the best way to cope with the overwhelming problems facing the characteristically understaffed and undertrained tax administrations...".[39] Bird warned though that any estimated tax system "should be introduced selectively, preferably concentrating on areas in which there is thought to be significant revenue potential and for which reasonable *quantitative* (not qualitative) information on indicators (of income) are available...".[40] Estimated taxes are simply a means of getting some contribution from the hard to tax group.

H. Objection and appeal process

Unless a fair and efficient mechanism is introduced to deal with objections and appeals, the process can soon become clogged up. There are also other benefits of early resolution, including lower compliance costs for taxpayers and greater satisfaction with the assessment process. In the first instance the tax administration is probably best placed to review objections. It is debatable whether this internal review is best conducted by the person responsible for the initial decision. However, if after internal review, a taxpayer is still dissatisfied there should be an independent review body to which the taxpayer can turn. It is not always necessary for this to be a court of law. In fact, except for disputes involving large amounts of money, it may be preferable for it to be a quasi-judicial body, similar to the Administrative Appeals Tribunal (AAT) in Australia. Quasi-judicial bodies have the advantage that they allows for less stringent rules of evidence to be followed. They also abide by less formal procedures for the conduct of hearings.[41] These should allow for matters to be resolved more quickly. In order that the system which is set up is not subject to abuse, thought might be given to using the pricing mechanism to limit the number of disputes coming forward. If a reasonably priced fee is charged[42] for taxpayers wanting to pursue a matter then, generally, only serious cases will be brought forward. This fee ought to be refundable where taxpayers successfully challenge their assessment.

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35. C. Penniman, *State Income Tax*, Johns Hopkins University Press, Baltimore (1980) at 139.
36. For instance, the IRS has 19 short videos available. The topics include tax tips for farmers, tax tips for fishermen, tax tips for children and tax tips for the elderly. The videos are available in English, Spanish and Chinese.
37. The benefit of having this as a long-term goal is that it allows administrative resources to be used more effectively on audit activities rather than unproductively on assessing returns.
38. For full details, see "Income Taxation of the Hard-to-Tax Groups", Chapter 17 of R. Musgrave, *Fiscal Reform in Bolivia: Final Report of the Bolivian Mission on Tax Reform,* International Tax Program, Harvard Law School, Cambridge (1981). But note that there are problems with both types of taxes. For instance, they are arbitrary and could lead to a greater number of disputes, and not only in circumstances when they undertax taxpayers; this is unfair to taxpayers who willingly comply.
39. R.M. Bird "Income Tax Administration in Developing Countries: The Administrative Dimension", 37 *Bulletin for International Fiscal Documentation* 1 (1983) at 3.
40. Ibid. at 11-12.
41. In Australia, the AAT implemented a "call-over" process. This allowed it to determine if both parties still wanted to proceed, if they could agree upon the facts, how long the case might take, if both parties were ready to proceed, etc. In many instances, this process resulted in the resolution or withdrawal of matters.
42. In the United States, filing fees for tax court appearances are either US$ 10 or US$ 60 depending on the nature of the matter. In Australia, the fee for referral to an Administrative Appeals Tribunal is AS$ 240.

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I. General aspects of administration

1. Record-keeping

It perhaps goes without saying that good record-keeping should be encouraged and poor record-keeping should be discouraged. Penalties are perhaps the best way of discouraging poor record-keeping. However, there are other ways. One other way might be to signal that poor records mean a higher probability of audit. Another way is to indicate that poor records might result in application of arbitrary assessments. If records are particularly bad, taxpayers' rights of appeal (or their rights on appeal) could be restricted, their entitlement to full deductions for expenses might be limited or their right to refunds for overpaid tax might lapse. Taxpayers should be made aware of the advantages of good record-keeping practices. In some instances it might be worth considering whether tax administrations should conduct training programmes in record-keeping or at least seminars on the record-keeping requirements.

It might also be helpful to consider separately the record-keeping requirements of business taxpayers and of non-business taxpayers. Because of the diverse nature of many businesses it might not be advisable to prescribe, too rigidly, business record-keeping requirements. What might be suitable for one class of business might not be suitable for another. Where record-keeping requirements are kept flexible revenue authorities ought to be able to ascertain what records, if any, have been kept and what procedures have been followed (e.g. has stock been counted or estimated, have debtors and creditors been taken into account, has income been recognized on a cash or an accruals basis).

Bookkeeping requirements can start out simple and be expanded once it is clear taxpayers become more competent. It has been said that as a general principle "record-keeping will be the more accurate if it is useful to the recorder for other purposes than just tax filing and administration. Records having no utility for the recorder and requiring separate procedures and forms are less likely to be accurate."[43] This is particularly relevant for developing countries. It suggests that they should concentrate on developing record-keeping requirements which are useful to taxpayers for general accounting or financial reasons. Where record-keeping requirements are either not in force or not enforced, efforts to improve the record-keeping requirements could start with selected groups. Groups such as professional taxpayers might be productive as these taxpayers should have the educational background necessary to keep the records required. Once these groups become compliant other groups can be targeted. In those countries in which professional associations have become reasonably well-organized, revenue authorities might try to encourage those organizations to develop and enforce record-keeping requirements among members. One simple enforcement mechanism might be to sanction members if they are discovered by revenue authorities to have kept grossly inadequate records. Professional organizations also tend to develop codes of ethical conduct which can positively influence compliance.

Record-keeping requirements for wage and salary earners who elect to itemize (i.e. list) their claims on their tax returns can be kept simple. In Australia, documentary evidence in the form of a receipt or invoice is sufficient.[44] The receipt or invoice should show at least the date the expenditure was incurred, a description of the goods or services acquired, the amount incurred and the name of the person who supplied the goods or services. This evidence does not have to be submitted with taxpayers' returns but must be produced, if required, within 28 days.

2. Access to information

Revenue officials need authority to enter buildings and places; to inspect books and records; to make copies of documents; to require taxpayers to attend and give evidence; and to require taxpayers to provide information. Whether they ought to have authority to seize documents is debatable. Developed countries provide examples where tax codes give revenue authorities the right to seizure (United States) and where they do not (Australia).

3. Salaries

Salaries of tax administration staff should be sufficient to attract and retain quality staff. Generous leave provisions should apply to encourage staff to undertake relevant training or further education in law, accounting or computing. The gap between salaries offered in the public and private sectors is a problem for all tax administrations. Where the gap becomes too large, in favour of the private sector, it means that the public sector will not be able to attract or retain suitable staff. In developing countries, low public sector salaries might also induce officials to accept bribes as a means of subsidizing their incomes.

Where branch activities are conducted, co-ordination of the separate activities is required to avoid problems with the issue of tax file numbers, the recording of lodgement of tax returns and the sharing of details reported on information returns.

A special unit should be set up, preferably outside the tax administration framework, to investigate alleged corruption or alleged abuse of power by tax administration officials. If resources are available, some should be used to measure non-compliance. This allows the administration to identify where non-compliance is worst, where resources ought to be directed, whether compliance is improving or whether it is deteriorating, etc.

4. Tax audits

With or without self-assessment, tax systems need

43. K.W. Smith and K.A. Kinsey "Cooperation and Control: Strategies and Tactics for Tax Examination", *Tax Administration Review* (December 1985) at 13, 18.
44. See Sec. 82KU(1) of the Income Tax Assessment Act 1936, as amended.

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some form of audits. Under self-assessment, the main purpose of audits is probably to maintain a deterrent effect in the taxpaying community. Under other systems audits play a different primary role. This could be to raise revenue or to ensure accuracy of returns. Revenue authorities must first define the goal(s) audits are to achieve before working out details about the nature of the audits and how returns are to be selected for audit. It is particularly important to ensure that staff sent out on audits have the skill to conduct the assigned task. Otherwise the audit will be ineffective and will be perceived to be ineffective. In either case, there will be deleterious effects on compliance.

J. Techniques directed at long-term-compliance

Legislatures and tax administrators must recognize that tax systems will be effective in the long term only if they have the cooperation of the vast bulk of taxpayers. There are a number of things which a legislature can do. For instance, it can start by keeping demands on taxpayer funds to a minimum. Perceptions that tax rates are too high can have a significant effect on compliance.[45] Related to this is the taxpayers' perceptions of how wisely a Government spends taxpayer money. Compliance will be significantly better if taxpayers perceive that the Government is spending taxpayer money wisely. However, where taxpayers perceive that the Government is wasting taxpayer money compliance is likely to decline. Governments must not only aim to eliminate waste, they must also convince taxpayers that taxpayer money is being spent wisely.

Eventually, Governments of developing countries could embark upon public education campaigns, even school programmes, to inform people about such things as the need for Government intervention, the need for specific programmes and the way in which public funds are spent. Some developing countries already have revenue officials train some secondary teachers about the country's tax system so that those teachers can pass on the information to high school students in social studies classes.[46]

In the short term, if compliance is particularly problematical, it can make use of tax compliance certificates which must be produced by taxpayers in a variety of situations, for example if taxpayers want a passport, if they want to tender for Government contracts, if they want foreign exchange, if they want to execute certain legal documents or if they want to operate on a bank account. In Nigeria, tax clearance certificates were also required as a prerequisite for applications for Government loans, registration of motor vehicles, lodgement of building applications, granting of trade licences, granting of business names and appointment to certain Government positions.[47] It is reported that, for self-employed taxpayers, tax collections trebled when this system was introduced.[48] To facilitate administration, the law should be drafted, to the extent possible, to limit the requirements for tax clearance certificates to those who are likely to have large tax obligations. Where the need for certificates becomes widespread tax administrations may well grind to a halt in trying to administer them.

A recent example in the United States of an initiative which will help taxpayers perceive that the tax system seeks to be fair is the enactment of the Taxpayer Bill of Rights.[49] While the IRS would argue that it was already doing many of the things that the legislation mandates, the Bill does ensure taxpayers of these rights. Amongst other things the Taxpayer Bill of Rights:

- requires the IRS when it contacts a taxpayer concerning the determination or collection of tax to notify the taxpayer in writing of the taxpayer's rights and the obligations of the IRS;
- requires the IRS, prior to an audit interview, to explain the audit process to taxpayers and to explain to taxpayers their rights under this process;
- permits taxpayers to be represented at interviews with the IRS;
- allows a taxpayer Ombudsman to issue assistance orders where taxpayers would otherwise suffer hardship because of the way in which the IRS was administering the tax laws.

There are also some things which a tax administration can do. For instance they can:

- develop a strategic plan to determine where the administration is at, where it is headed, and what its priorities are;
- reassess its administrative structure to determine whether it is appropriate for the priorities it has set itself;
- provide assistance to taxpayers who have questions with any aspects of the tax laws. In the United States, a toll-free telephone service is provided. Use of information booths in public places, such as shopping centres, can also help. They have the advantage of giving the appearance of helping as well as showing that the tax administration is approachable;
- explore ways of using the mass media to publicize such things as new tax laws, taxpayers' annual return obligations, the penalties for evasion, the enforcement activities which are conducted, the types of people who are caught trying to avoid their taxpaying responsibilities, etc.;
- organize outreach programmes;
- encourage the establishment of self-help and voluntary help groups. In the United States, for in-

45. See I.G. Wallschutzsky, "Possible Causes of Tax Evasion", 5 *Journal of Economic Psychology* (December 1984) at 371-384.
46. J. Pounder, "Voluntary Compliance: Myth or Reality?" in *The Challenge of Tax Administration Until the End of the 20th Century*, op. cit. footnote 11.
47. Cited in J.M. Elegido, "The Nigerian Experience with Tax Clearance Certificates", 42 *Bulletin of International Fiscal Documentation* 6 (1988) at 263. This article also focuses on some of the problems which can arise in implementing a Tax Clearance Certificate system.
48. Ibid. at 263.
49. Enacted as part of the *Technical Corrections and Miscellaneous Revenue Act of 1988*. The Taxpayer's Bill of Rights is reprinted in 43 *Bulletin for International Fiscal Documentation* 1 (1989) at 35.

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stance, a voluntary assistance programme has operated successfully since 1969;[50]
- provide material for inclusion in school curriculums. Again, in the United States the IRS has, since 1953, provided such material;[51]
- encourage senior officers to become members of community groups; this not only allows them to become more familiar with taxpayers' affairs but can be used to promote greater liaison with the tax administration which is needed for long-term cooperation of taxpayers;
- develop liaison with professional accounting and law groups to identify administrative and other problems within the tax system. This liaison could also be used to assist with the drafting of legislation.

IV. CONCLUSIONS AND RECOMMENDATIONS

As a preface to the conclusions and recommendations on compliance goals for developing countries it is helpful to recall the following warning by Bird:

> Most fancy schemes to improve tax administration, for example, collapse of their own weight – by creating information overload (elaborate "cross checking" schemes), by overcentralising (rigid "master tax roll" schemes), or by postulating miracles (the instantaneous creation of a well paid, well trained group of "incorruptible officials").[52]

Bird also reminds that in developing countries one should "introduce change with caution, incrementally and experimentally"[53]. Without being in any particular order, the conclusions can be briefly stated as:
- Keep the tax laws as simple as possible;
- Aim for a global tax with few exemptions, credits, rebates, or deductions;
- Do not try to use the tax system to achieve too many social and economic goals;
- Try to keep tax rates as low as possible;
- Try to keep tax rates as flat as possible;
- Seek measures which enhance long-term cooperation of taxpayers;
- Continually monitor the tax system;
- Seek advice from interested groups;
- Concentrate on basic tasks such as collection of tax at source and an ID number system;
- Do not collect more information than can be processed;
- Do not discriminate between different business structures;
- Do not let taxpayers gain an advantage by late payment of tax;
- Actively encourage good record-keeping; and
- Aim, as a long-term goal, for self-assessment. This allows scarce administrative resources to be used for audit activities which are likely to be more revenue productive. However, it does require a certain degree of literacy and fiscal cognizance of taxpayers or their agents.

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50. Reported in S. Goldberg, "Taxpayer Assistance, Information and Education" in *Measures for Improving the Level of Voluntary Compliance with Tax Obligations,* International Bureau of Fiscal Documentation, Amsterdam (1985) at 146.
51. Ibid. at 148 for fuller details.
52. R.M. Bird, "Income Tax Reform in Developing Countries: The Administrative Dimension" 37 *Bulletin for International Fiscal Documentation* 1 (1983) at 13, 14.
53. Ibid. at 14.

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Income Taxes in Argentina
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INTERNATIONAL: CONSUMPTION TAXES IN OECD COUNTRIES OVER THE LAST TWO DECADES 255

In December 1988, the OECD published a report which surveys consumption taxation in its Member countries between 1967 and 1988 with an analysis of the policy choices facing Governments in taxing goods and services. The report also surveys the practical problems in implementing and introducing value added taxation. After summarizing the main findings of the OECD report, the authors conclude that a number of important and often conflicting policy objectives are involved.

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1989 BUDGETS: 270

It's Budget time again! This issue features several articles highlighting the 1989 Budgets of Hong Kong, India, Singapore, South Africa, Sri Lanka and Swaziland. The most discernible link between the Budgets is the well-chosen adjectives used to describe several of them.

*The **Hong Kong** Budget has been labelled "predictable and boring" and "supply-side". The Hong Kong Government faces a major political change in less than 10 years and combined with the increasing demands for substantial capital expenditure from a narrow tax base it is not surprising that the Budget is indeed a circumspect one. The proposals regarding indirect taxes mainly seek to maintain existing levels broadly in line with inflation. The standard rates of tax will be reduced to 16.5% for corporations and 15% for others. The interest withholding tax will be abolished. The basic personal allowance will be increased as has been the child allowance. A new HK$ 20,000 allowance for single parents with dependent children will also be introduced.* **270** **274**

*The **Indian** Budget has been dubbed "lacklustre", a "sugar-coated pill" and a "tightrope walking". This Budget invites a contest between fiscal pragmatism and electoral aspirations. The defence expenditure and Budget deficit were pegged down to last year's levels and a couple of poverty alleviation and rural employment programmes served the electoral ambitions of the ruling party. The four "aces" of taxation on the affluent, i.e. a surcharge on income tax, doubled expenditure tax, higher air fares and more expensive luxury items have been emphasized but the heavier tolls in the form of increased excises, prices and inflation will harm the poorest of the poor.* **277** **280**

*The **Singapore** Budget can be perceived as either "pro-business" or "pro-family" as a result of the changes made to company taxation and the child and procreation incentives. The tax changes affecting business include a reduction in the corporate tax rate, extension of the one-year accelerated depreciation allowance to automation equipment and an exemption from withholding tax for swap transactions which are carried out between ACUs and non-residents and which do not involve the Singapore dollar. The child reliefs have been increased and a special rebate is now available for the births of third and fourth children.* **283**

*Emphasizing that the **South African** Budget was not an election Budget, the Finance Minister announced an increase in the primary rebate. In respect of mining taxation, a new tax formula is to be introduced.* **286**

*The most remarkable feature of the **Sri Lanka** Budget is the imposition of a 15% surcharge on all income and wealth tax (the surcharge is payable for the 1989/90 and 1990/91 years of assessment) and an additional turnover tax to be collected and remitted by manufacturers and importers on behalf of their dealers/customers.* **289**

*In **Swaziland,** the top marginal rate of tax for individuals is reduced from 45% to 40% and the distinction between the rates of tax for married, unmarried and wives' employment income is abolished and replaced by a uniform rate for all taxpayers. The withholding tax rate on non-resident contractors and other non-resident companies has been increased from 5% to 10%.* **291**

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TRINIDAD AND TOBAGO: TAX REFORM PROPOSALS .. 292

Major tax reform proposals were announced when the 1989 Budget was presented to Parliament. Some of these proposals have already been enacted into law. This note outlines the details of some of the reform proposals.

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Ken Messere et John Nørregard:

International: Taxes sur la consommation dans les pays de l'OCDE au cours des deux dernières décades 255
L'OCDE a publié en décembre 1988 un rapport donnant une vue d'ensemble de l'imposition sur la consommation dans ses pays membres entre 1967 et 1988, ce rapport analyse les différentes possibilités offertes aux gouvernements pour l'imposition des biens et services. Le rapport résume également les problèmes pratiques posés par la mise en œuvre et l'introduction de la taxe sur la valeur ajoutée. Les auteurs, après avoir résumé les principales conclusions du rapport de l'OCDE, considèrent qu'y sont impliqués un certain nombre d'objectifs importants et souvent incompatibles.

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Ken Messere und John Nørregard:

International: Verbrauchsteuern in OECD-Ländern während der letzten zwanzig Jahre 255
Die OECD veröffentlichte im Dezember 1988 einen Bericht über die von 1967 bis 1988 in ihren Mitgliedstaaten erhobenen Verbrauchsteuern und gab in diesem Bericht eine Analyse der Wahlmöglichkeiten für die Regierungen, um Waren und Dienstleistungen zu besteuern. Der Bericht gibt ausserdem eine Übersicht über die Probleme, die in der Praxis bei der Einführung und Erhebung der Mehrwertsteuer entstehen können. Die Autoren fassen die wichtigsten Schlussfolgerungen des OECD-Berichtes zusammen und folgern, dass es eine Anzahl von wichtigen, jedoch oft gegensätzlichen politischen Zielsetzungen gibt.

Veranstaltungskalender 268

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Budgets 1989 ..... *270*
Voici revenu le temps des budgets. Ce numéro est consacré aux points les plus importants des budgets d'Afrique du Sud, de Hong Kong, d'Inde, de Singapour, de Sri Lanka et de Swaziland; ce sont les qualificatifs adéquats utilisés pour définir chacun d'eux qui en constituent le point commun.

Le budget de Hong Kong a été défini comme étant "prévisible et ennuyeux" *270*
ainsi que "supply side". *274*
Le gouvernement de Hong Kong va être confronté dans moins de 10 ans à un changement politique considérable et ceci en combinaison avec des demandes croissantes de dépenses en capital substantielles avec une assiette étroite d'impôt; il n'est donc pas surprenant que ce budget soit circonspect. Les propositions, quant aux impôts indirects, cherchent essentiellement à maintenir les niveaux existants en harmonie avec l'inflation. Les taux normaux de l'impôt seront réduits à 16,5% pour les sociétés et à 15% pour les autres. La retenue à la source sur les intérêts sera supprimée. Les allocations personnelles de base ont été augmentées ainsi que celles accordées pour les enfants à charge. Une nouvelle allocation de 20 000 HK$ a été introduite en faveur des parents célibataires ayant des enfants à charge.

Le budget indien a été qualifié de "terme" de "pilule adoucissante" *277*
et de "démarche de funambule". *280*
Ce budget peut entraîner des conflits entre le pragmatisme fiscal et les aspirations électorales. Les dépenses pour la défense et le déficit budgétaire ont été maintenus au niveau de l'an passé tandis que des mesures d'allègement de la misère et des programmes d'emplois ruraux servent les ambitions rurales du parti au pouvoir. Les quatre "as" de l'imposition, à savoir: une surcharge de l'impôt sur le revenu, la taxe hôtelière spéciale, une augmentation des prix des voyages aériens et des produits de luxe ont été mis en avant mais les barrières plus lourdes sous la forme d'augmentation des droits d'accise, des prix et de l'inflation vont nuire aux plus pauvres parmi les pauvres.

Le budget de Singapour peut être défini comme étant soit "pro-entreprises" soit "pro-familial", en raison des modifications apportées d'une part à l'imposition des sociétés et d'autre part aux avantages familiaux. Les modifications fiscales applicables aux entreprises comprennent une réduction du taux de l'impôt sur les sociétés, l'extension de l'application du système de l'amortissement accéléré à l'équipement informatique et une exemption de la retenue à la source pour les transactions portant sur les crédits croisés effectuées entre les "ACUs" et des non-résidents, lorsque le dollar Singapour n'est pas impliqué. Les allocations en faveur des enfants ont été augmentées et une réduction spéciale est maintenant prévue pour les troisième et quatrième enfants. *283*

Le ministère des Finances d'Afrique du Sud, en insistant sur le fait que son budget n'était pas un budget "électoral", a annoncé une augmentation de l'abattement à la base. Une nouvelle formule fiscale va être introduite en matière d'imposition minière. *286*

Le point le plus important du budget du Sri Lanka est la surcharge de 15% introduite sur tous les impôts sur les revenus et sur la fortune (la surcharge est due pour les années d'imposition 1989/90 et 1990/91) ainsi qu'une taxe sur le chiffre d'affaires additionnelle qui doit être perçue et payée par les entrepreneurs et importateurs au nom de leurs fournisseurs/clients. *289*

Le taux maximum de l'impôt sur le revenu des personnes physiques est réduit au Swaziland de 45% à 40% et les différents taux applicables selon qu'il s'agit de personnes mariées, de célibataires ou de femmes mariées sont supprimés et remplacés par un taux uniforme pour tous les contribuables. La retenue à la source pour les contractants et sociétés non-résidents a été portée de 5% à 10%. *291*

John Rodway:

Trinidad et Tobago: Propositions de réforme fiscale *292*
Les propositions de réforme fiscale les plus importantes ont été annoncées au moment de la présentation du budget de 1989 au Parlement. Certaines de ces propositions ont déjà été promulguées sous forme de loi. Cette note résume les détails de quelques-unes de ces propositions de réforme.

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Die Haushaltpläne für 1989 ..... *270*
Die Haushaltpläne für 1989 sind wieder da! Dieses Heft enthält eine Anzahl von Artikeln, die im kurzen die Haushaltpläne von Hong Kong, Indien, Singapur, Südafrika, Sri Lanka und Swaziland beschreiben. Die am meisten ins Augen fallende Gemeinsamkeit dieser Pläne sind die gut gewählten Adjektive; welche zu ihrer Beschreibung gebraucht wurden.

Der Haushalt Hong Kongs wurde „vorhersehbar und langweilig" *270*
und „supply-side" bezeichnet. Die Regierung Hong Kongs *274*
erwartet in weniger als 10 Jahren eine fundamentale politische Änderung und in Kombination mit den zunehmenden Anforderungen für hohe Kapitalinvestierungen, die nur von einer schmalen Steuergrundlage finanziert werden können, kann man sich nicht wundern, dass der Haushalt sehr vorsichtig erstellt worden ist. Die Vorschläge, welche die indirekten Steuern anbetreffen, versuchen hauptsächlich, die Steuerbelastung im ungefähren Gleichschritt mit der Inflation zu halten. Die normalen Sätze für Körperschaften werden bis auf 16,5% und für andere Steuerpflichtige bis auf 15% herabgesenkt. Die Quellensteuer auf Zinsen wird abgeschafft. Der allgemeine Freibetrag und die Kinderfreibeträge für natürliche Personen werden erhöht und die Einführung eines neuen Freibetrages von HK$ 20.000 für unverheiratete Eltern mit jungen Kindern wird vorgeschlagen.

Den indischen Haushalt hat man mit „trüb", „eine versüsste Pille" *277*
und „Seiltanz" bestempelt. In diesem Haushalt streiten *280*
der Pragmatismus auf dem Steuergebiet und die politischen Bestrebungen um den Vorrang. Die Verteidigungsausgaben sowie das Haushaltsdefizit wurden auf demselben Stand gehalten wie im letzten Jahr und eine Anzahl von Programmen für die Armutbestreitung und für die Verschaffung von Arbeitsplätzen in der Landwirtschaft dienten dem politischen Ehrgeiz der regierenden Partei. Die vier meist beliebten Methoden, um die besser gestellten Kreise zu besteuern, d.h. die zusätzliche Einkommensteuer, die verdoppelte Ausgabensteuer sowie höhere Preise für Flugscheine und für Luxusgüter, wurden mit Nachdruck erwähnt, höhere Lasten in Form von höheren Akzisen, Preisen und Inflation wird jedoch die Allerärmsten am härtesten treffen.

Den Haushalt Singapurs kann man als „pro-Geschäft" oder *283*
„pro-Familie" betrachten wegen der Änderungen der Körperschaftsbesteuerung und wegen der Steuervergünstigungen, die man für Kinder und für Familienzuwachs vorgesehen hat. Die Körperschaftsteueränderungen betreffen u.a. die Senkung des Körperschaftsteuersatzes, die Ausdehnung der einjährigen Sonderabschreibung auf Automatisierungsausrüstung und die Befreiung von der Quellensteuer für Tauschgeschäfte zwischen ACUs und beschränkt Steuerpflichtigen, vorausgesetzt, dass diese Geschäfte nicht den Singapur-dollar betreffen. Die Steuervergünstigungen für Kinder sind erhöht worden und ein besonderer Abzug wird für die Geburt eines dritten und vierten Kindes gewährt.

Der südafrikanische Finanzminister betonte, dass sein Haushalt *286*
nicht auf die Wahlen gerichtet war und gab nur bekannt, dass der allgemeine Steuerabzug (primary rate) erhöht wird. Mit Bezug auf die Besteuerung von Bergwerkgesellschaften hat er eine neue Steuerformel in Aussicht gestellt.

Die meist auffallende Charakteristik des Haushaltes in Sri Lanka ist *289*
die Einführung eines 15%igen Zuschlages auf die Steuern vom Einkommen und Vermögen (der Zuschlag ist für die Veranlagungszeiträume 1989/90 und 1990/91 verschuldet) sowie eine zusätzliche Umsatzsteuer, die von Herstellern und Importeuren zu Lasten ihrer Händler und Kunden einbehalten und bezahlt wird.

In Swaziland hat man den Höchstmarginalsatz für natürliche *291*
Personen von 45% auf 40% gesenkt und den Unterschied zwischen sowohl den Steuersätzen für verheiratete und ledige Steuerpflichtige als auch für verheiratete Frauen abgeschafft und durch einen einheitlichen Satz für alle Steuerpflichtige ersetzt. Daneben hat man auch den Satz für die Quellensteuer auf ausländische Bau-Unternehmer und sonstige ausländische Körperschaften von 5% auf 10% erhöht.

John Rodway:

Trinidad und Tobago: Vorschläge zur Steuerreform *292*
Als die Regierung den Haushalt 1989 im Parlament einreichte, gab sie weitgehende Steuerreformvorschläge bekannt. Eine Anzahl dieser Vorschläge sind bereits verabschiedet worden und in Kraft getreten. Diese Notiz fasst die Einzelheiten einiger dieser Reformvorschläge kurz zusammen.

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INTERNATIONAL:

Consumption Taxes in OECD Countries over the Last Two Decades

Ken Messere and John Nørregard

The authors are members of the Fiscal Affairs Division of the Directorate for Financial, Fiscal and Enterprise Affairs of the Organisation for Economic Co-operation and Development. The views expressed do not commit in any way the OECD or its Member Governments to agreement with them.

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I. INTRODUCTION

OECD has published (December 1988) a report[1] which provides a survey of consumption taxation in its Member countries between 1967 and 1988 with an analysis of the policy choices that Governments have had to make in taxing goods and services as well as a comprehensive survey of practical problems in implementing and introducing value added taxation (hence-forth VAT). This article[2] summarizes the main findings of the OECD publication and also gives some personal views of the authors with regard to policy choices for countries with or without VAT.

It is generally accepted that the most striking development in the tax world over the last 2 decades has been the spread of VAT. In the mid-sixties VAT did not exist in OECD countries, except in a not fully developed form in Finland and France. By the end of 1988 VAT has been adopted in 18 out of 24 OECD countries and legislation has been passed to bring it into operation in Iceland and Japan in 1989. The Canadian Government also has announced its intention of adopting VAT, so that the only OECD countries uncommitted to VAT are Australia, Switzerland and the United States. This article accordingly reflects the report in concentrating mainly on VAT, although references are also made to other general and selective consumption taxes.

II. THE MOVE TOWARDS VALUE ADDED TAXATION

A. Main reasons for the move

Among the interconnected reasons for this move are:
- to make consumption taxes more neutral with respect to consumer choices, producers' decisions and international trade;
- to bring the tax nearer to that on final consumption of households rather than on business inputs;
- to raise greater amounts of revenues from consumption taxation;
- to join the European Communities where the adoption of VAT is a mandatory condition of membership.

1. The report is entitled "Taxing Consumption".
2. This article is a much-expanded version of a short article by the same authors published in "The OECD Observer" end January 1989.

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B. VAT and other consumption taxes

1. A taxonomy of taxes

What constitutes "consumption taxes" is itself a debated question in public finance literature. The term is intended to refer to taxes on expenditure on goods and services purchased by final consumers (i.e. mostly households) in the country imposing the tax,[3] but ambiguity arises because other kinds of taxes, while initially imposed on income, profits, payroll, property values, etc., may result in an increase in the price of consumer goods and services, and conversely vendors may not be able to pass on to the consumer the totality of an increase in tax on goods and services in which case such a tax will result in lower profits or lower salaries and wages. This so-called "shifting" or "incidence" problem cannot be resolved and taxes on consumption are generally taken to be the taxes on goods and services of heading 5000 in the annual OECD Publication "Revenue Statistics of OECD Member Countries". The main subsections of heading 5000 are reproduced in Table 1 with an indication of their relative importance in revenue terms in 1986 and how this has changed since 1965.

Table 1
Classification of consumption taxes and their revenue importance

		Unweighted OECD average as percentage of total consumption tax receipts (1986)	(1965)
5000	Taxes on goods and services	100	100
5100	Taxes on products, sale, transfer, leasing and delivery of goods and rendering of services	94.3	93.9
	5110 General taxes (e.g. VAT and sales taxes)	51.0	32.3
	5120 Taxes on specific goods and services	43.0	61.6
	5121 Excises	32.4	40.0
	5122 Fiscal monopolies	0.8	2.6
	5123 Customs and imports duties	5.2	15.1
	5124 Taxes on exports	0.1	0.1
	5125 Taxes on investment goods	0.3	0
	5126 Taxes on specific services	3.4	3.2
	5127-8 Other taxes (including those unallocable	0.8	0.6
5200	Taxes on use of goods, or on permission to use goods or perform activities	5.7[1]	6.1[2]

1. Of which 3.4% represents revenues from motor vehicle licence taxes.
2. Of which 3.6% represents revenues from motor vehicle licence taxes.

A general consumption tax is one levied on a relatively wide range of goods and perhaps services and is contrasted with selective taxes on consumption, of which by far the most important are those on the activities of drinking, smoking and motoring. Among general consumption taxes, a distinction first has to be made between single-stage taxes where tax is charged at only one point in the production/distribution chain (i.e. whether on sales from manufacturers to wholesalers (MST) or on wholesalers to retailers (WST) or on retailers to consumers (RST)), and multi-stage taxes, where tax is charged each time a product or its components is sold in the chain from manufacturer – assembler – wholesaler – retailer. Under multi-stage taxes, a further distinction has to be made between cumulative or cascade taxes under which traders receive no credit for tax paid on their purchases and non-cumulative or VAT where tax on purchases is generally refunded to traders who subsequently resell.[4] Table 2 shows the system in force in OECD countries in January 1967 and in January 1989.

2. Single-stage taxes

MST and WST are generally regarded as bad taxes. In OECD they now exist only in Australia (WST) whose Government tried unsuccessfully in 1985 to move to RST and in Canada (MST-federal level only) whose government is currently trying to replace it with VAT. Among the disadvantages of MST (which apply in somewhat mitigated form to WST) are the following:

- The amount of tax included in the price of similar goods selling at similar retail prices may vary greatly because of variations in manufacturers' prices to different trade levels (wholesalers, retailers, consumers) or the inclusion in the prices of some manufacturers of costs such as advertising and transport that may be excluded by others.
- Profits at the wholesale and retail stages typically differ between products: valuable items like jewellery normally have higher mark-ups than mass-produced items like office furniture. An MST at a single rate will accordingly have a lower effective rate (i.e. tax expressed as a percentage of the retail price) on products like jewellery than on office furniture, and to vary rates creates other distortions.
- Manufacturers will refrain from undertaking such activities as packaging, transportation, storage, insurance and market research, which in the absence of an MST they might be expected to perform.
- If a tax is levied at the manufacturer level, its coverage has to be relatively narrow, so it may prove an inadequate tool to meet the revenue requirements of Governments. Alternatively, to raise appropriate revenues, rates may have to be relatively high, which enhances the distortive effects referred to above.
- To compensate for the narrowness of the base, MST may need to include certain producers' goods so that the tax becomes partially a tax on business inputs rather than on household consumption.

3. A completely different way of taxing consumption, much discussed, but nowhere in operation, is the so-called "direct expenditure tax" under which goods and services actually purchased are ignored, and the tax is levied on aggregate consumption expenditures (i.e. income minus saving plus spending out of capital). However, such a tax is generally regarded as an alternative to a personal income tax rather than to an indirect consumption tax.
4. For a discussion of how VAT operates in practice, see Sections II B and II C.

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Table 2
General consumption tax systems in 1967 and 1989

	1 January 1967	1 January 1989	Year VAT introduced
Australia	W	W	No VAT
Austria	C	VAT	1973
Belgium	C	VAT	1971
Canada	M[1] + R[2]	M[1] + R[2]	No VAT
Denmark	W	VAT	1967
Finland	VAT[3]	VAT	1964
France	VAT[4]	VAT	1954
Germany	C	VAT	1968
Greece	M	VAT	1987
Iceland	R	R	1989 (July)
Ireland	W + R	VAT	1972
Italy	C	VAT	1973
Japan	None	None	1989 (April)
Luxembourg	C	VAT	1970
Netherlands	C	VAT	1969
New Zealand	W	VAT	1986
Norway	R	VAT	1970
Portugal	W	VAT	1986
Spain	C	VAT	1986
Sweden	R	VAT	1969
Switzerland	R[5]	R[5]	No VAT
Turkey	None	VAT	1985
United Kingdom	W	VAT	1973
United States	R[6]	R[6]	No VAT

	Number of countries[7]	Number of countries[8]
Single-Stage		
M Manufacture	2	1
W Wholesale	6	1
R Retail	7	4
Multi-Stage		
C Cascade	7	0
VAT Value Added Tax	2	18
No General consumption	2	1
	26	25

1. At federal level.
2. At provincial level.
3. Partial only. Full VAT in 1976.
4. Partial only. Full VAT in 1968.
5. W in certain cases.
6. At state and local level only.
7. Canada and Ireland counted twice.
8. Canada counted twice.

3. Multi-stage taxes

Cascade taxes have most of the disadvantages of MST, especially in being largely a tax on business inputs instead of on household consumption. They also have 2 other important disadvantages. First, they produce economic distortions by inducing firms to undertake manufacturing, assembling, wholesaling and retailing operations simply to avoid the tax which would be payable on sales between independent firms carrying out such activities separately. Second, because similar goods bear different rates of tax according to the number of times they and their components have been bought and sold, compensating levies at the border for imports and exports have to be an average,[5] which even if roughly correct will give an export subsidy to integrated firms and insufficient compensation to unintegrated firms for tax already paid on their exports. Likewise, integrated firms will be paying less cascade tax and unintegrated firms more cascade tax than the average charged on importers of similar goods. Such averaging thus entails a distortion of international competition and renders the cascade system especially inappropriate in a Common Market. For these reasons cascade systems have been replaced by VAT in all the 7 countries which had them (see Table 2).

4. Kinds of VAT

Table 3 provides a classification of the main possible kinds of VAT. Of countries actually operating VAT, all countries except Finland and Turkey use a net-value consumption-type tax employing the indirect subtraction method (i.e. 3C in the Table), but Japan has chosen to adopt a direct subtraction method (type 3A) and this is one of the options contemplated by Canada under the title "business transfer tax". Finland is a mixture of 1B and 1C as regards coverage and follows 3B as regards method; Turkey follows route 1B in that normally VAT on depreciable capital goods is credited equally over a 3-year period.

Value added can be calculated in 2 ways. It can be built up from its component parts (which, broadly, are the payments made by the firm to the factors of production it employs – wages, profits, rents and interest) – the so-called "addition method" of 2A; or it can be derived from the difference between the value of the firm's output (the price at which it sells its goods and services) and that of its inputs (the price it pays for the goods and services it buys from its suppliers) – the subtraction method of 2B. The "addition" methods seeks to identify and tax the components of value added (wages and profits), while a subtraction method VAT taxes the difference between inputs and outputs. The direct subtraction method takes the aggregate value of sales and the aggregate value of purchases over a period and taxes the difference between them. The indirect subtraction method requires businesses to collect tax on their individual sales (outputs) and pay tax on their individual purchases (inputs) and hand over to the revenue authorities the difference between the tax collected and the tax paid for each tax period.

With the addition method there may be problems in defining taxable profits or of making exact border adjustments. Also, it is difficult to operate on any basis but a single rate and to relieve specified goods and services by exemption. However, there may be more opportunity for its use in respect of economic activities where inputs and outputs are difficult to measure, as in banking and finance. But in practice it is not used in any OECD countries. The direct subtraction method is in principle the simplest[6] but this method is also difficult to operate where more than one tax rate is levied and where it is desired to exempt particular goods and services.

5. Under the international rules of the game, consumption taxes are charged in the country where the goods are consumed. This entails that consumption taxes of the exporting country be removed and those of the importing country be imposed on internationally traded products. This topic, discussed in Chapter 7 of the report, is not covered in this article.
6. This is perhaps why Japan has adopted it, since it envisages adopting VAT within 4 months, whereas a preparatory period of a year or 2 at least has been found necessary in large countries in the past.

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Table 3
A summary of possible types of VAT systems

1. *Possible coverage of VAT systems*

A	B	C
A tax on all sales with no deduction at all for business inputs	Deductions for capital goods limited to their depreciation value	Deductions for business inputs immediately deductible
GROSS PRODUCT TYPE VAT	NET INCOME TYPE VAT	NET CONSUMPTION TYPE VAT

2. *Possible methods of operating net consumption type VAT*

A	B
Identification of value-added by the summation of all the elements of value-added (wages, profits, rent and interest)	Identification of value-added by the difference between inputs and outputs
ADDITION METHOD	SUBTRACTION METHOD

3. *Types of subtraction methods under net consumption type VAT systems*

A	B	C
Deducting the aggregate tax-exclusive value of purchases from the aggregate tax exclusive value of sales and taxing the difference between them (Japan)	Deducting the aggregate tax-inclusive value of purchases from the aggregate tax inclusive value of sales and taxing the difference between them (Finland)	Deducting tax on inputs from tax on sales for each tax period (nearly all OECD countries)
DIRECT SUBTRACTION METHOD	INTERMEDIATE SUBTRACTION METHOD	INDIRECT SUBTRACTION METHOD

The main advantages of the indirect subtraction method over the addition or direct subtraction methods are its greater flexibility and its greater possibility of detecting tax evasion which is why it has been adopted in OECD countries.[7] Future references to VAT in this article assume the existence of a net consumption tax with the indirect subtraction method.

OECD countries have opted for net consumption-type tax systems because only under such a system can cumulative taxation of investment goods be avoided. The European Communities harmonization policy also influenced this decision, since, as already noted, subjecting capital goods to a quasi-consumption type tax could create international competitive distortions. Nevertheless, for a variety of reasons there has to be some departure from the ideal VAT on final consumption only, of which the most important are:

- To prevent evasion, countries may disallow deductions for tax on certain business inputs, which introduces elements of a gross product type tax (1A) or a net income type tax (1B). Purchase of company cars is a typical example, where deduction of VAT may be disallowed for these reasons.
- To raise revenue, Governments may introduce or continue separate taxes outside the VAT systems, which have similar effects to a VAT of type 1A or 1B. Important examples here are the Swedish tax on energy and the Norwegian tax on investment goods.
- To move from 1A type cascade taxes to 3C type VAT, most countries retained a transitional and declining tax on capital goods which was subsequently abolished.

5. VAT in operation

In principle, VAT could be a relatively simple tax to operate. A trader includes the tax in all prices of goods and services sold, and periodically makes payments to the tax authorities of that tax reduced by the amount of VAT he has paid on his purchases from other traders.

The operation of the VAT can alternatively be viewed from the perspective of a typical chain of transactions: goods produced by a manufacturer are sold to a wholesaler who sells to a retailer, who sells to a consumer. As the wholesaler gets a refund from the tax authorities for the VAT included in the price he is charged by the manufacturer, the net cost of the goods to the wholesaler remains unaffected by the tax and the Government collects no revenue (in net terms) from this transaction. The same situation applies when the goods are sold by the wholesaler to the retailer. However, as the consumer is not entitled to any refund in respect of the VAT included in the price paid to the retailer, it is at this point that the tax can be said to form part of the net cost of the goods to the purchaser and that revenue from the tax accrues to the Government.

In order to complete a tax return and correctly account for the tax, most traders would need to do little more than issue invoices for sales to other traders, retain invoices received in respect of purchases from other traders, and maintain a daily record of the value of sales and purchases. From such records, the trader is

7. For fuller details of the reasons why, see para. 5.24 pages 82-3 of the report.

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able to determine periodically the tax payable (by calculating the fraction of sales and purchases that constitute VAT) and the tax authorities are able to verify the deduction of VAT paid on purchases made from other traders (through the issue and retention of invoices by both parties).

VAT's theoretical simplicity is reduced in practice by political or administrative needs of Governments to have a multi-rate system and on limited base, to have separate regimes for certain traders and in some cases to provide transitional measures when VAT has replaced cascade taxes. These 3 aspects are commented on in turn.

a. *Multi-rates and exemptions*

In practice, for the distributional objectives[8] discussed in Section IVB, nearly all OECD countries have used zero rating, exemptions[9] and multiple rates in their VAT systems. Such features complicate the VAT for most traders. For example, a trader supplying both goods taxed at the standard rate and some other rate must record his sales separately in order to account for VAT to the tax authorities. A trader selling both taxable and exempt goods must not only separately record the 2 types of sales, but also his business purchases – distinguishing between those related to taxable sales (the VAT being deductible) and those related to exempt sales (no credit given for VAT). The problems of apportioning purchases that are not directly related in their entirety to either type of supply (e.g. advertising, overheads, plants and machinery) provide further complications.[10]

Such provisions also complicate the tax for consumers who may not be certain that particular goods or services are subject to the tax and, if so, at what rate. Also, it is impossible in most cases for a consumer to determine what is the "hidden" VAT component in exempt goods and services (i.e. the VAT paid by the supplier on purchases).

b. *Special regimes*

Even under a VAT in its simplest form, traders would be required to maintain records of sales and purchases and to regularly complete returns using those records. For traders already maintaining an accounting system for management purposes or to meet the requirements of other taxes (e.g. corporate or personal income taxes), a simple VAT is likely to impose the extra burden of the periodic completion of returns. In most OECD countries, this would probably be the case for the bulk of traders. However, for some, even a relatively basic form of accounting may be too difficult.

Where the accounting requirements of a VAT exceed what a trader is otherwise undertaking, the trader will have some extra costs. These may arise from the extra time involved in recording transactions to the required detail, from the need to seek professional advice or assistance (e.g. from an accountant or lawyer), and from changes to manual or computerized systems already in place. Such costs generally bear more heavily on small-scale traders and on those who already rely heavily on professional accountants and other advisors. This would place such traders at a disadvantage relative to those for whom the costs are not as great.

Consequently, VAT systems generally feature special provisions to relieve certain traders of the requirement to account for tax (through not having to register) or by simplifying the calculation of tax for those who are registered (e.g. by allowing accounting to be done on the basis of cash received and paid). Such concessions have, in practice, generally been restricted to small-scale traders (i.e. those with turnover of tax liability below certain levels), farmers and retailers.

While no doubt simplifying the administration of the VAT for those traders covered, such provisions may themselves make the tax as a whole more complex and even present new problems for some traders. For example, special schemes that simplify the tax calculation often do so at the expense of accuracy so that using a special scheme may increase a trader's liability for tax at the same time as decreasing costs of compliance. The main example is the option of small-scale traders not to register, which though relieving them of compliance costs, entails that they can obtain no refund of VAT on their purchases and for many traders it may not be clear whether or not it would be to their advantage to register for the tax.

c. *Transitional problems*

The replacement of a previous general consumption tax by VAT poses some problems which often necessitate the provision of special transitional measures, especially if the previous tax was a cascade tax.

Where a trader has purchased capital equipment or trading stock prior to the introduction of the VAT, previous tax may have been paid on the equipment or stock. A similar purchase made after the VAT comes into effect will have a lower net cost to the trader as the VAT included in the purchase price of the equipment or stock is refundable. Clearly, any trader holding trading stock at the time a VAT comes into effect is disadvantaged relative to the trader whose stock was purchased after that time. To remedy this and to avoid any potential distortions in buying patterns (e.g. by traders delaying stock and capital purchases until after the VAT is introduced), 2 solutions exist. Either traders can be reimbursed for the tax element on stock or assets on hand at the time the VAT comes into effect or previous tax can continue to be levied and be phased out gradually.

8. There are certain major transactions for which the standard VAT mechanism is not suited. These include the supply of financial services (particularly borrowing and lending money, insurance and residential accommodation).

9. Under zero-rating, goods or services are not subject to tax when sold and the supplier is able to claim a refund for any VAT paid on purchases. In this way, zero-rated goods and services include no VAT at all. In contrast, while exempt goods and services are also not subject to tax on sales, the supplier is denied credit for any VAT paid on purchases.

10. While tax authorities generally provide simplified methods of calculating the apportionment, these are often available to only small-scale traders, are usually not very accurate, and sometimes do not fully relieve the trader of the necessity to classify purchases separately.

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The first solution has been adopted in most OECD countries for trading stock and the second for capital equipment. Each, however, complicates the operation of the tax.

6. VAT vs. RST

Although there is general agreement that RST is the best form of single stage tax and VAT the best form of multi-stage tax, there is less unanimity on the relative merits of RST and VAT, even if country practices and theory lean heavily in favour of VAT. As noted in Section C, under VAT all registered traders pay taxes on their sales and receive credits for tax paid on their purchases. Under RST, payment of tax occurs only on sales from registered traders to unregistered traders or to consumers and no refund of tax is involved. There has been much confusion between what is necessary, what is possible and what actually happens in practice under RST and VAT, but commentators generally agree that RST and VAT are economically equivalent since both are intended to be and mostly are taxes on final consumption. Nevertheless, important differences do follow from the different collection methods of the 2 kinds of tax of which the most important are summarized below.

Although VAT systems require accounts to be kept of both purchases and sales of registered traders whereas RST systems are concerned only with their sales, it is difficult to provide valid comparative figures of these relative administrative costs for Governments and compliance costs for traders and they will doubtless vary according inter alia to what records traders are accustomed to keep (for their own accounting, income taxes, etc.) and how rigorously under either RST or VAT systems tax authorities pursue anti-evasion measures. In addition, any additional costs of VAT may be offset for Governments by increased revenues and for traders by the advantages of having more efficient accounting systems.

The need for traders under VAT to reclaim input tax provides VAT with a number of control weapons unavailable under RST even if VAT is certainly not evasion-proof and there may be a number of practical constraints on the use of these control weapons. The view has, however, been expressed that RST is too vulnerable to evasion to sustain high rates of tax and apart from Iceland and some Canadian provinces, RST rates are always lower than VAT rates. In addition, in a number of VAT countries, there is an integration of control of personal and corporate tax and of VAT, which is more difficult to achieve under RST.

Many services are much more easily taxed under VAT than RST, because there is no need to check on the end use of the service under VAT whereas there is such need under RST. It is largely for this reason that services are rarely taxed under RST (and when they are, at low rates) whereas they are extensively taxed under VAT.

There are methods of doing this under both RST and VAT but VAT is generally considered the more efficient method, again because of the lesser need to look at end use.

III. THE CONTRIBUTION OF VAT AND OTHER CONSUMPTION TAXES TO GOVERNMENT REVENUES

A. Introduction

Governments may wish to increase consumption tax yields to change the tax mix (less reliance on the other major taxes) or to increase the tax level (total tax receipts to GDP). In the first case it is appropriate to look at consumption tax receipts as a percentage of total tax receipts, in the second as a percentage of GDP. Chart 1 uses the first ratio and Table 3 the second.

B. Where do tax revenues come from?

Perhaps because it can be so painful to pay certain taxes (e.g. on property, net wealth, bequests, corporate profits), it is not generally appreciated that in nearly all OECD countries around 85% of tax revenues derive from only 3 kinds of taxes: consumption taxes, personal income taxes and social security contributions (see Chart 1).[11]

A major reason for the choice of VAT was the belief that alone among consumption taxes it had the potential to halt the drastic move in most OECD countries between the early sixties and mid-seventies away from consumption taxes towards income and payroll taxes. VAT duly fulfilled this function, since, as the top half of Chart 1 shows, there has been general stability in overall relative reliance on the 3 major revenue raisers since the mid-seventies, and the bottom half of Chart 1 shows that this has been due to the increase in general rather than selective consumption taxes.[12] However, other reasons are required to explain why this almost universal shift away from consumption taxes occurred and why it was subsequently halted.

During most of the sixties and early seventies the combination of high growth and inflation pushed taxpayers into higher rate tax brackets and at the same time eroded the value of their tax reliefs. This so-called fiscal drag phenomenon enabled income tax revenues to increase without any change in legislation. In addition, with rising standards of living, taxpayers did not protest against, or perhaps did not even notice, the

11. Some Governments prefer to regard social security contributions as other than taxes and it is true that certain contributions may have an element of an insurance premium and in some countries may be perceived in a different way from other taxes. They are, however, clearly taxes, being compulsory, payable to Government and unilateral (i.e. rewards obtained bear no predetermined relation to contributions paid). Moreover, social security benefits have to be paid for somehow and whether this is done mostly or entirely by earmarked social security contributions or unearmarked other levies is a matter of political choice which varies greatly between countries.

12. See also Table 1 in Section II.B., which indicates the great decline in revenues from excises and imports over the last 2 decades.

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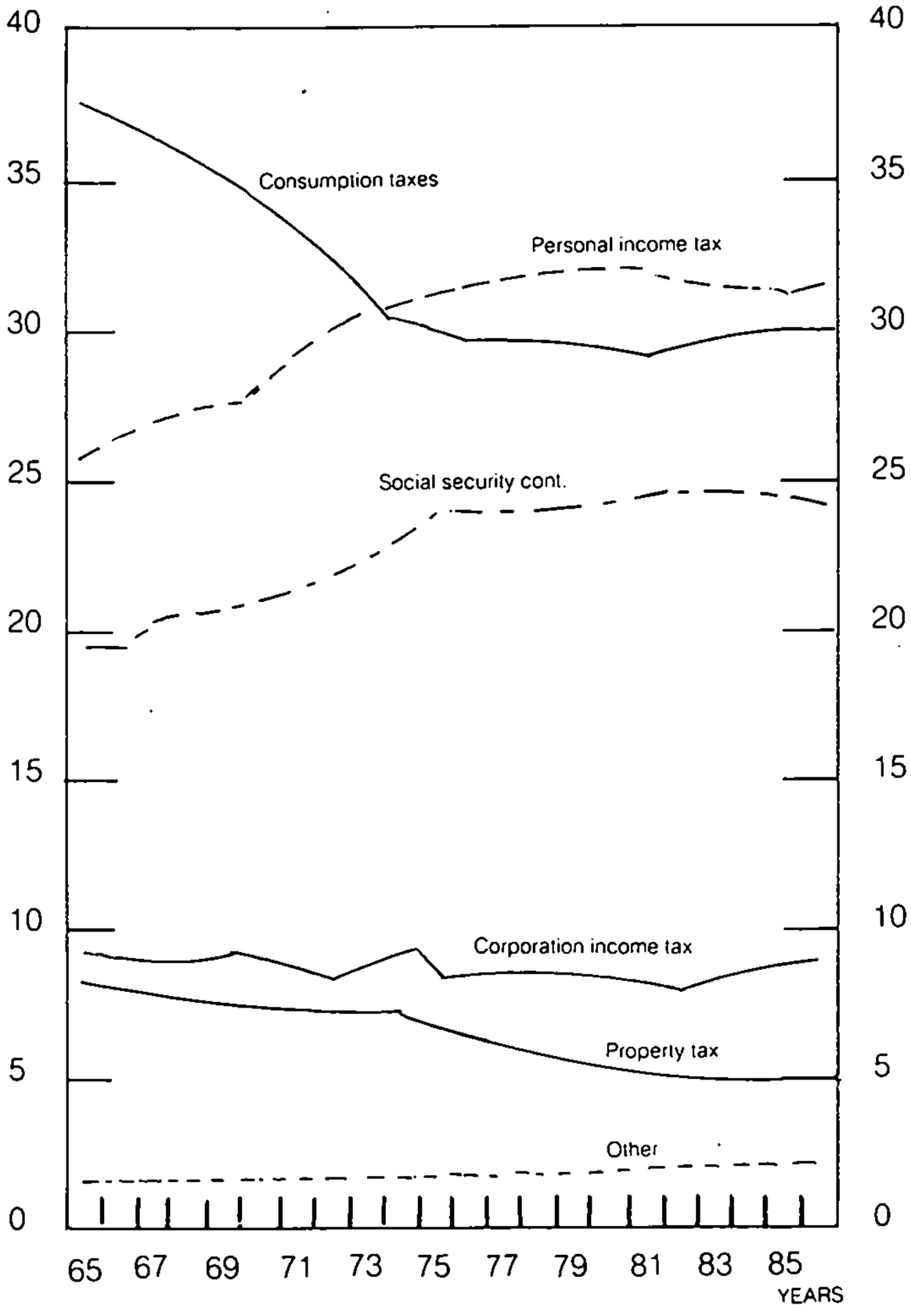
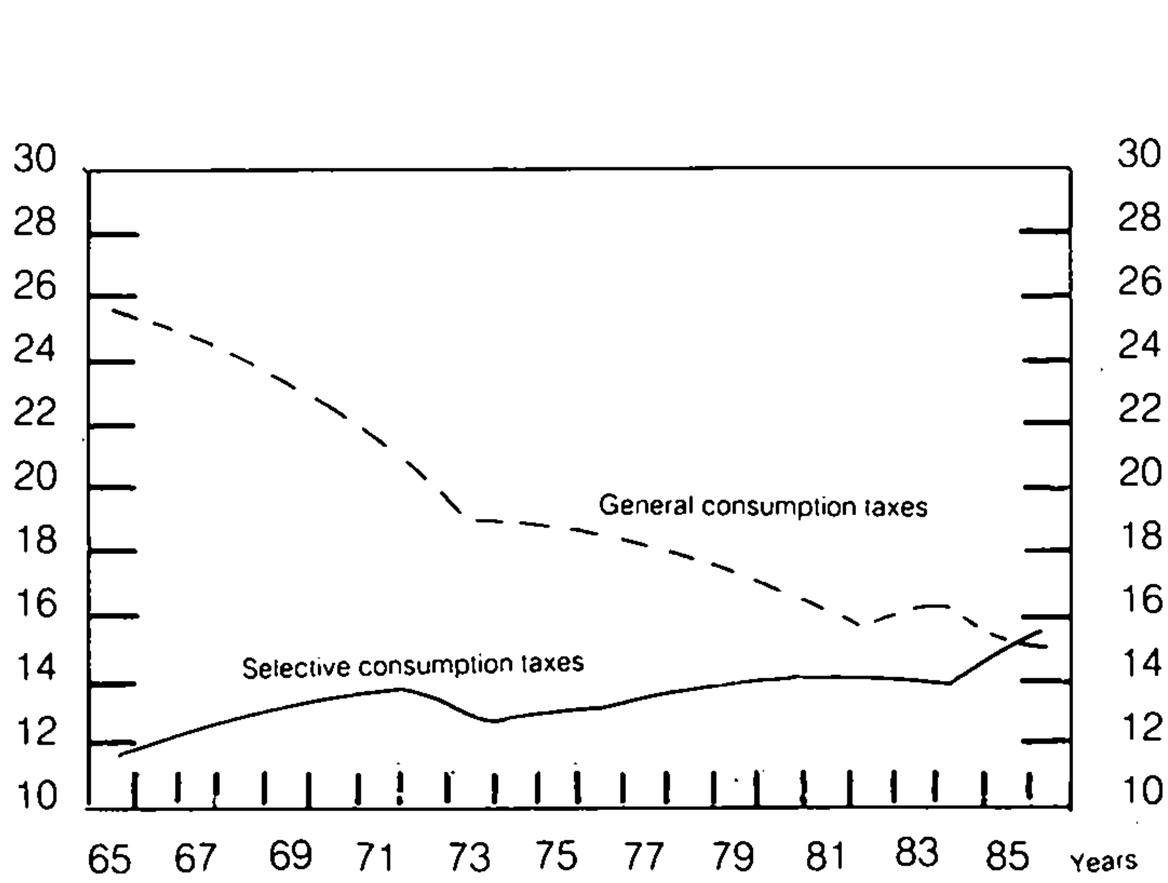
Chart 1
Developments in the share of the major revenue sources as percentage of total tax receipts
(Unweighted OECD average)





increase in their income tax bills; nor did they object to increases in social security contributions to support their welfare states, especially as these contributions were often perceived as a quasi-insurance payment. Consumption taxes, however, require an increase in rates to bring in more revenue (and in the case of most selective consumption taxes even to raise the same amount of revenue in real terms)[13] and in those heady days most Governments felt no need to take such unpopular measures.

After the first oil shock with stagflation and falls in real disposable incomes taxpayers were no longer prepared to pay increasing amounts of income tax and rather demanded reductions or negotiated wage increases in net of tax terms; nor, with increasing levels of unemployment, could payroll taxes remain a buoyant source of revenue. Governments were accordingly forced to return back to consumption taxation. Rates of both general and selective consumption taxes were raised and the general consumption tax base was frequently broadened, generally by bringing services into the tax net.

Finally (apart from New Zealand and the South European countries recently introducing VAT), it is worth emphasizing that this trend away from consumption taxes has only been halted, not reversed. A number of Governments have expressed a desire to change the tax mix towards consumption taxes but few have done so in recent years: opposition to perceived distributional consequences and inflationary effects are probably responsible.

C. Is VAT a money-making machine?

This is how the question has been posed and Governments wanting to introduce VAT would prefer a negative answer to avoid frightening their voting taxpayers. Without the compensation of heavy cuts in income or payroll taxes or without the need to adopt it to join the European Communities, Governments have not always been successful in the pursuit of VAT. "TVA – taxe va augmenter" – was a slogan which helped its rejection in the Swiss referenda. The Japanese Government has failed on more than one occasion to introduce VAT even if it has now succeeded in introducing VAT at the unparalleled low rate of 3%. Concern has been expressed frequently in the United States at allowing the Federal Government access to such a large potential source of revenue.

The top half of Table 4 compares general consumption tax receipts of first generation VAT countries (i.e. those countries having introduced VAT before 1974) in 1975 and 1985 with such receipts from other countries and their relative growth over these years. It shows that VAT receipts in 1975 were invariably

13. This is because the majority of revenues from selective excises are based on the strength of alcohol, weight of tobacco and volume of mineral oils, which decline in real terms under inflationary conditions. Negative fiscal drag of excises, together with the growth of VAT, accounts for the growth of general consumption tax receipts relative to selective consumption tax receipts as illustrated at the bottom of the chart.

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higher as a percentage of GDP than those from other general consumption taxes (Greece excepted) and that in all countries (except France) they grew more as a percentage of GDP than receipts from general consumption taxes in those countries with VAT. The unweighted average of general consumption tax to GDP of first generation VAT countries in 1975 and 1985 was around twice that of other countries and between 1975 and 1985 it grew by nearly twice as much.

It may, however, be argued that consumption taxes should be looked at as a whole since non-VAT countries may be expected to rely more on selective consumption taxes to meet their consumption tax revenue needs and the bottom half of Table 2 does that. The picture is then somewhat modified. First generation VAT countries' total consumption tax to GDP ratios mostly remain higher than those of other countries and have grown more rapidly, but there are many exceptions (e.g. compare Germany and Italy with pre-VAT Greece and Portugal as regards amounts and compare Austria, Belgium and Germany with Greece, Portugal and Spain as regards growth in total consumption tax ratios).

It seems that everyone can take comfort from the figures in the table regarding the light they shed on the question "Is VAT a money-making machine?" The answer is it can be but does not have to be and that sometimes it is and sometimes it is not. However, it is fair to add that in most countries it does increase revenues with the consequence that OECD Governments have become increasingly in agreement that they are handicapped in the absence of VAT to finance increasing expenditures, to reduce income or payroll taxes, to cut back Budget deficits, or to achieve some mixture of these goals.

Table 4
General and total consumption tax receipts as percentage of GDP
(in 1975 and changes between 1975 and 1985)
(Figures represent percentage points)

GENERAL CONSUMPTION TAX REVENUES

First generation VAT countries	1975	75-85	1985
Austria	7.7	1.3	8.9
Belgium	6.5	0.9	7.4
Denmark	7.0	2.9	9.9
Finland	6.3	1.6	7.9
France	8.6	0.0	8.6
Germany	5.3	0.7	6.0
Ireland	4.6	3.4	8.0
Italy	3.6	8.4	5.0
Luxembourg	4.7	0.8	5.5
Netherlands	6.3	1.0	7.3
Norway	9.2	–0.5	8.7
Sweden	5.3	1.7	7.0
U.K.	3.1	2.9	6.0
Unweighted average:	6.0	1.4	7.4

Other countries[1]	1975	75-85	1985
Australia	1.8	0.6	2.4
Canada	4.0	0.4	4.4
Greece	4.7	1.3	6.0
New Zealand	2.8	0.8	3.5
Portugal	2.8	1.1	3.9
Spain	3.0	1.1	4.1
Switzerland	2.3	0.7	3.0
United States	1.9	0.3	2.2
Unweighted average:	2.9	0.8	3.7

TOTAL CONSUMPTION TAX REVENUES

First generation VAT countries	1975	75-85	1985
Austria	13.3	0.5	13.8
Belgium	10.8	0.6	11.4
Denmark	13.9	2.9	16.8
Finland	12.1	1.6	13.7
France	12.3	1.1	13.4
Germany	9.7	0.0	9.7
Ireland	14.7	3.7	18.4
Italy	7.4	1.4	8.8
Luxembourg	8.2	2.0	10.2
Netherlands	10.6	1.0	11.6
Norway	16.8	1.1	17.9
Sweden	10.7	2.6	13.3
U.K.	9.0	3.0	12.0
Unweighted average:	11.5	1.6	13.1

Other countries[1]	1975	75-85	1985
Australia	8.1	1.7	9.8
Canada	10.4	0.0	10.4
Greece	11.9	3.3	15.2
Japan	3.6	0.3	3.9
New Zealand	7.6	0.4	8.0
Portugal	10.1	3.1	13.2
Spain	4.7	2.9	7.6
Switzerland	5.9	0.2	6.1
Turkey	8.6	–1.5	7.1
U.S.	5.4	–0.2	5.2
Unweighted average:	7.6	1.0	8.6

1. Excluding Japan which lacks a general consumption tax and Turkey that lacked one before 1985, when it amounted to around 5% of GDP.

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IV. POLICY OPTIONS AND ISSUES

A. Criteria for a good consumption tax

To assess the relative advantages and disadvantages of a consumption tax, benchmarks are needed. Depending on the specific situation in question (most of) the following basic criteria are normally chosen:

1. *Neutrality:* The tax should interfere as little as possible with the choices made by producers and consumers, i.e. the economic distortions resulting from changing relative prices compared to the pre-tax situation must be minimized.

2. *Fairness:* The tax must have politically acceptable distributional consequences, i.e. taxpayers with the highest tax capacity should bear the highest burden, or, alternatively, the tax should be accompanied by appropriate changes in other taxes or in social transfer systems to alleviate or neutralize negative distributional consequences.

3. *Price stability:* The tax should not lead to sustained inflationary pressures either at the time of introduction or in the longer run.

4. *Revenue aspects:* The tax should supply the Government with the amount of tax revenues required and reduce as far as possible the possibility of tax evasion and avoidance (which could also be seen as a condition relating to fairness).

5. *Administrative and compliance costs:* The tax should aim at minimizing the Government's administrative costs and trader's compliance costs.

These criteria may conflict. For example, fairness may conflict with neutrality and administrative simplicity as discussed in the next subsection.

B. Multi-rate vs. single-rate VAT

The term "neutrality" would refer ideally to a situation where the tax has no influence whatsoever on the behaviour of producers and consumers, i.e. they continue to behave as if the tax were not imposed, and the tax therefore would have no negative effect on production and welfare. In reality, this situation is very rare in the sense that almost all taxes have distortive effects. A more realistic aim, therefore, is to minimize tax-induced distortions.

There seems to be a fairly general agreement that neutrality requires that the tax in question has the broadest possible base and only one rate, which in fact rarely happens in the VAT systems in force in Member countries (see Table 5).

The main argument in favour of such multi-rate systems in spite of their distortive effects and thereby economic costs is that, by exemption or zero-rating basic necessities like foodstuffs and medicine consumed in relatively large proportions by low income earners, the tax burden on these families may be alleviated.

Table 5
VAT rates in OECD member countries[1]
(As at January 1988)

Country	Lower rates[1]	Standard rate[2]		Higher rates
Austria	10	20	(59)	32
Belgium	1, 6, 17	19	(35)	25, 33
Denmark	–	22	(100)	–
Finland	–	19.05	(100)	–
France	2.1, 4, 5.5, 7, 13	18.6	(86)	33⅓
Germany	7	14	(90)	–
Greece	3, 6	18	n.a.	36
Ireland	0, 2.4, 10	25	(57)	–
Italy	2, 9	18	(74)	38
Luxembourg	3, 6	12	(55)	–
Netherlands	6	20	(90)	–
New Zealand	–	10	(100)	–
Norway	–	20	(100)	–
Portugal	0, 8	16	(70)	30
Spain	6	12	(66)	33
Sweden	–	23.5	(96)	–
Turkey	1, 3, 8	12	n.a.	15, 50, 60, 100
United Kingdom	0	15	(100)	–

– Non-existent.
n.a. Not available.
Minor departures (e.g. Sweden) omitted.

1. Excluding some minor zero rating, also exemptions which in some countries account for a substantial part of total consumption.
2. Figures in parentheses show latest information available on percentage of yield deriving from standard rate (and do, therefore, not necessarily correspond to the rates shown).

In addition to the basic argument about lack of neutrality, a multi-rate consumption tax system suffers from a number of other more practical problems. First, the goods and services in each rate category have to be clearly defined which – being difficult – may lead to ambiguities and thereby distortions, tax evasion and higher administrative and compliance costs. Second, lower rates, zero-rating or exemptions extend the tax relief to individuals and families with higher incomes. Due to this problem of precise "targeting", the revenue cost of providing the relief may be relatively high leading to a higher tax rate on taxable goods and services to provide a certain revenue, thereby accentuating the distortive effects of a multi-rate system (in countries with VAT higher than standard rates are of any revenue significance only in Belgium and Italy).

Multi-rate versus single rate VAT also raises issues other than those relating to neutrality or distributional effects. Whatever the theoretical and practical advantages of a single rate VAT, moving from a multi-rate general consumption tax to a single rate poses difficult problems. One is that such a change will provoke a shift in relative prices which may hurt certain sectors in the economy and possibly cause employment problems in these specific sectors. To the extent that prices generally are more upward than downward flexible, the shift in relative prices may furthermore increase the general level of inflation. Another reason is that countries with multi-rate systems face various objections to moving to what would probably be a more regressive system. It is perhaps for these kinds of reasons that except for New

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Zealand there is no OECD country which has moved from a multi-rate general consumption tax to a single-rate one.

Apart from imposing lower and higher rates, some countries do not impose VAT on certain goods and services either by zero-rating them (where credit is given for tax paid on inputs) or by exempting them (where credit is not given). In Portugal, and more importantly in Ireland and the United Kingdom, a relatively high proportion of total consumption is zero-rated. The zero rate issue may be considered as a special case of the multi-rate versus single rate debate, since from the point of view of distorting economic choices or increasing administrative or compliance costs there would seem to be little difference between having 5% or zero rate as a lower rate to accompany a standard rate to say 14% to 20%. However, other arguments are advanced both for and against zero rates. In favour of zero-rating, pressure groups in Ireland and the United Kingdom argue first that there is an inherent case for not taxing certain essential goods (e.g. basic foods) or merit goods (e.g. books) and second, and more pragmatically, that even if a small VAT rate of 3% or 4% would have little social or economic effects once such goods were in the VAT net, rates would be likely to be increased later. Against zero-rating, the EC has always taken the view that the maximum practicable coverage of goods and services should be aimed at and evidently if zero-rating remained, the EC goal of getting approximation of rates within the Community would be hampered. Another obstacle to a single rate VAT is, therefore, that the Commission of the European Communities has advocated a 2-rate system of between 14% and 20% for most goods and between 4% and 9% for certain defined essentials. Moving from a one-rate or a more than 2 rate system to a 2-rate system will evidently raise problems for many of its Member countries, as will complying with the designated range of rates.

C. Rationale for excises

It seems appropriate in the context of this discussion on multi-rate general consumption tax systems to summarize briefly the arguments for and against the existence of excises since Governments in some countries are confronted with a choice of using either higher rates of general consumption tax or excises, though this is generally not the case with what is called the "major excises", i.e. those levied on the activities of drinking, smoking and motoring, which account for the bulk of revenue from selective consumption taxes. The main question could be formulated as follows: given the dictum that a non-distortive consumption tax must have as broad a base as possible and apply only one rate, what is the raison d'être for excises, which apparently depart from this "ideal"? Apart from the very important facts that excises are among the oldest forms of taxation existing in OECD countries and that they provide easily collectible sums of revenue at low cost, which Governments in general cannot afford to forego, there are a number of other reasons why the existence of excises may be defended:

- The goods in question can be precisely defined, typically cover large transactions and there are no close substitutes that cannot be included in the coverage.
- The demand is relatively inelastic, thereby leaving consumer expenditure almost unchanged when the tax is imposed or changed and minimizing distortions in consumer behaviour.
- Governments may in some cases want to override the neutrality criterion in order to discourage over-consumption of certain goods (alcohol and tobacco) or services (gambling) which may inflict damage not only on the consumer himself but also on others; or Governments may for other reasons want to economize with the demand for the product in question (e.g. energy).
- Excise may in some cases be seen as payments covering public or social costs incurred by the consumption activity, such as the use of roads in connection with motoring activity and health costs associated with the activities of drinking, smoking and motoring, i.e. an element of private market mechanism is introduced in order to reveal preferences and determine the optimal supply of the goods and services in question. Following the same line of thought, in cases of negative externalities associated with economic activities such as, for example, pollution, some Governments want to implement the "polluter must pay" principle by way of excising the polluting activity.

D. Some empirical findings on distributional effects

Though consumption taxes are not in practice seen as a tool of redistributive policies, their distributional effects have, nevertheless, played – and still play – an important role in the discussion of these taxes. The general position on part of Governments seem to be that consumption taxes are necessary for other reasons and if they entail unwanted distributional effects, other measures should be found to alleviate these effects. Two questions are, therefore, of relevance in this context: what are the distributional effects of consumption taxes, and, if unwanted, what can Governments do to mitigate these effects?

Unfortunately, the empirical evidence provided by Member countries for the report is insufficient for confident generalizations and additionally suffers from a number of statistical and conceptual deficiences. The main results are summarized in Table 6 for the few countries which were able to provide extensive statistical information. The Table shows the consumption tax actually paid in households classified in decile groups (i.e. in tenths of the total population starting with the 10% – first decade – with the lowest incomes or consumption) measured as a percentage of their income or consumption expenditure.

International comparability is limited for a number of reasons, including:

- calculation of effective tax rates of this kind assumes full forward shifting of the taxes (i.e. con-

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Table 6
Distribution of consumption taxes in selected countries: all households

Country/Denominator	Tax as percentage of consumption/income in decile groups[1]										
	1[2]	2	3	4	5	6	7	8	9	10[2]	Average
DENMARK (1981)											
Consumption											
VAT	14.6	14.1	13.7	13.4	13.3	13.3	13.4	13.5	13.5	12.9	13.4
Excises	6.4	7.1	7.4	7.3	6.6	6.5	7.0	7.0	6.6	5.6	6.6
TOTAL	21.0	21.2	21.1	20.7	20.3	19.9	20.4	20.4	20.1	18.5	20.0
Gross income[3]											
VAT	17.1	14.1	11.4	9.3	8.6	8.0	7.5	6.9	6.5	5.4	7.6
Excises	7.1	6.9	5.4	4.8	4.3	4.0	3.8	3.4	3.0	2.3	3.6
TOTAL	24.1	21.0	16.8	14.1	12.9	12.0	11.3	10.4	9.6	7.7	11.2
Disposable income											
VAT	45.7	17.6	16.1	14.9	14.2	13.1	12.9	12.3	11.8	9.7	13.1
Excises	19.6	9.0	8.2	7.7	7.6	6.6	6.3	6.0	5.8	4.5	6.5
TOTAL	65.3	26.6	24.4	22.6	21.8	19.7	19.2	18.3	17.5	14.3	19.6
NETHERLANDS (1983)											
Consumption											
VAT	7.4	7.2	7.8	7.6	8.1	8.1	8.2	8.3	8.5	8.5	8.1
Excises	1.8	2.2	2.3	2.3	2.2	2.3	2.4	2.4	2.2	2.2	2.3
TOTAL	9.1	9.5	10.1	10.0	10.3	10.4	10.6	10.7	10.7	10.7	10.4
Disposable income											
VAT	8.6	7.2	8.2	7.7	8.3	8.1	7.7	7.6	7.4	6.6	7.6
Excises	2.1	2.2	2.4	2.4	2.3	2.3	2.3	2.3	1.9	1.7	2.1
TOTAL	10.7	9.5	10.6	10.0	10.6	10.4	10.0	9.9	9.4	8.4	9.6
SWEDEN (1985)											
Consumption											
VAT	11.1	11.0	11.0	10.9	10.9	10.5	10.6	10.5	10.6	10.7	10.7
Excises	4.9	5.2	5.1	4.9	5.0	5.1	5.0	4.9	4.8	4.5	4.9
TOTAL	16.0	16.2	16.0	15.7	15.9	15.6	15.6	15.3	15.3	15.2	15.6
Gross income											
VAT	19.6	12.1	10.2	8.9	8.5	8.2	7.8	7.5	7.4	6.5	8.6
Excises	7.6	5.0	4.6	4.1	4.0	3.8	3.7	3.6	3.7	2.8	3.9
TOTAL	27.3	17.1	14.8	13.0	12.5	12.1	11.5	11.2	11.1	9.3	12.5
Disposable income											
VAT	15.7	12.6	11.8	11.2	11.2	11.2	10.8	10.7	10.7	10.4	10.4
Excises	6.7	5.0	5.2	5.0	5.2	5.1	5.1	5.2	5.4	4.6	5.2
TOTAL	22.3	17.5	16.9	16.3	16.4	16.3	15.9	15.8	16.1	15.0	16.5
UNITED KINGDOM (1985)											
Consumption											
VAT	6.3	6.0	6.5	7.1	7.8	8.0	8.2	8.8	9.3	9.5	7.8
Excises	8.8	9.5	9.8	10.0	10.3	10.4	9.6	9.5	9.5	7.6	9.5
TOTAL	15.1	15.5	16.3	17.1	18.1	18.5	17.8	18.3	18.8	17.0	17.3
Gross income											
VAT	6.9	6.9	7.5	7.6	7.2	7.0	6.6	7.0	6.4	5.9	6.9
Excises	8.9	9.0	10.0	9.4	8.6	8.2	7.4	7.2	6.4	5.4	8.1
TOTAL	15.9	15.9	17.4	17.0	15.8	15.2	14.0	14.2	12.9	11.3	15.0

1. Indirect effects included for Sweden (only the housing sector) and United Kingdom, but excluded for other countries (see paragraph 8.25).
2. The 1st decile group contains the lowest 10% of incomes/consumption while the 10th decile group contains the highest 10% of incomes/consumption.
3. In all cases the income concept used refers to current income.

Sources: See Appendix 2 to this Chapter.

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sumers bear the full burden of the taxes) which may be the case to varying degrees in countries and over time;
- the time period differs among countries;
- indirect consumption tax effects (such as VAT on construction and on intermediate goods) have only been included to a limited – and varying – degree.

Some very broad observations are, however, suggested by the data. First and foremost, they support the intuitively plausible view that measured on the basis of expenditures, consumption taxes are broadly proportional while measured against income they tend to be regressive (i.e. they fall as a proportion of income as income increases). Because of the progressive nature of income taxes, the regressiveness of consumption taxes is clearer when gross income is applied instead of disposable income (i.e. gross income minus income tax and social security contributions), e.g. Sweden and Denmark. Especially for the Netherlands and the United Kingdom, the overall impression of the distributional impact of these taxes is, however, strongly influenced by what happens at the extreme ends of the distribution which is not the case in the 2 Scandinavian countries.

There are 3 ways of alleviating any negative distributional effects of general consumption taxes:

(1) within the consumption tax system itself, i.e. through multi-rates, zero-rating and exemptions;
(2) within the rest of the tax system, e.g. by rendering the income and payroll taxes more progressive, or, as proposed in Canada, by granting non-wastable tax credits to low income taxpayers in respect of VAT deemed to have been paid on essential purchases of food, etc.;

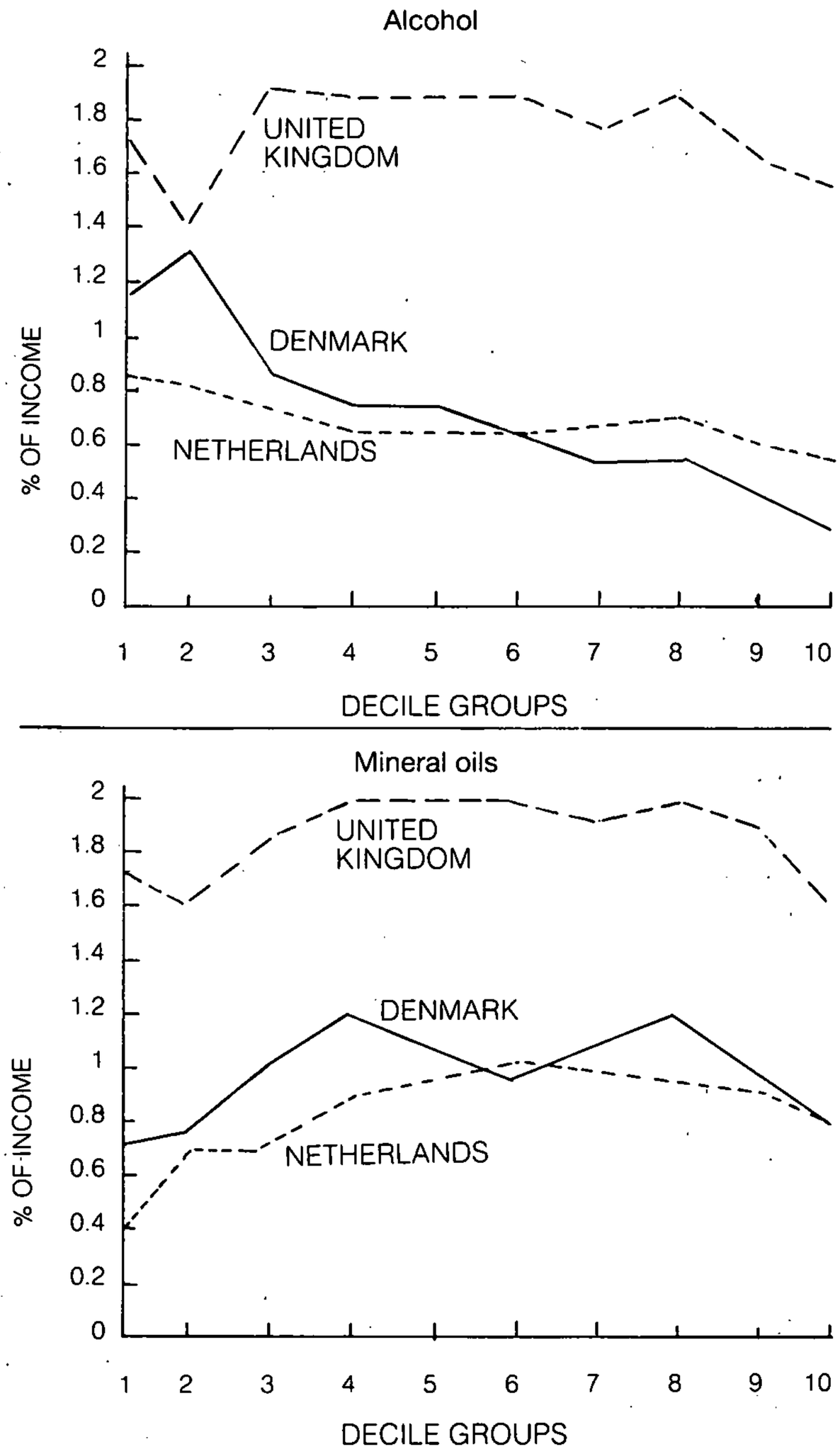
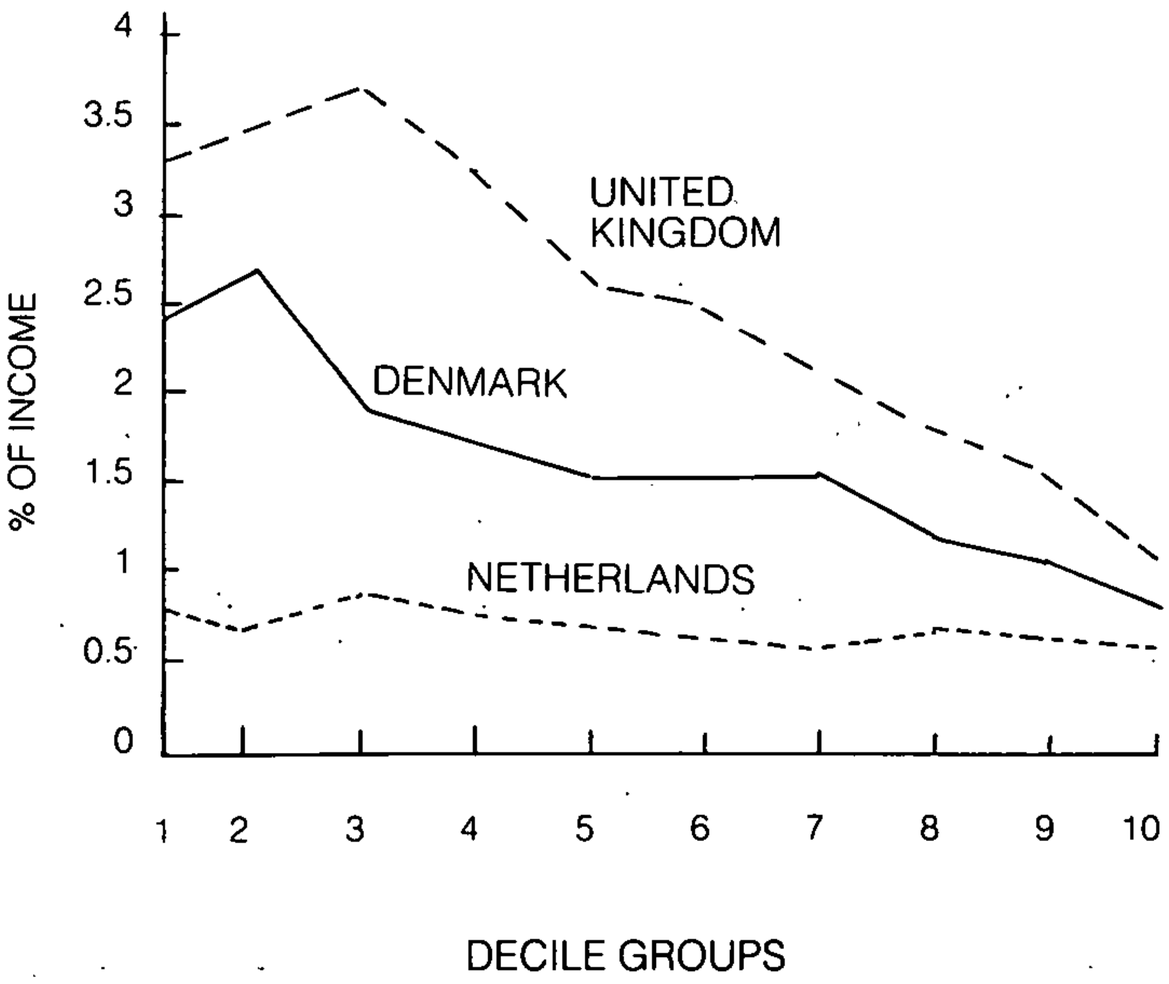


Chart 2
Tobacco



(3) outside the tax system, i.e. transfer payments to low income families.

Examples can be found of all 3 solutions.

Turning now to the major excises, the limited empirical data on the distribution of excise burdens concerning tobacco, alcohol and mineral oil excises provided for the report is summarized in Chart 2 (in which only income is used as denominator). As is seen from the Chart, tobacco excises are almost invariably regressive, and thus represent a typical example of a case in which one policy objective (i.e. health) conflicts with another (i.e. vertical equity). Mineral oils excises, on the other hand, tend to be mildly progressive, whereas alcohol excises exihibit no general distributional pattern except that they are mildly regressive in Denmark and the Netherlands. Doubtless beer, wines and spirits would exhibit different distributional patterns if it had been possible to make this breakdown.

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E. The inflationary impact of introducing or increasing VAT

This has been a vital issue in the countries that have already introduced VAT systems and is so also in countries in which the introduction of a VAT is still under discussion (i.e. in Canada and the United States as well as non-OECD countries such as Yugoslavia). The very limited empirical evidence seems to indicate that in most, though not all, countries the introduction of a VAT has had little or no effect on retail prices. The reasons why this is so tend to differ: for example, the varying monetary policy stance adopted by different countries, the existence of different price control systems. Experience also shows that countries have applied different policy measures in order to counteract perceived inflationary pressures following from the introduction of a VAT, e.g. by temporary price freezes or by timing the introduction to an appropriate point in the business cycle.

F. VAT in a federal context

It is probably no accident that the 4 countries still without VAT (Australia, Canada, Switzerland, United States)[14] are all federal states. Apart from the possibly greater resistance among states, provinces, cantons, etc. to giving the Federal Government a greater tax handle, complications arise when, as in Canada and the United States, there are already retail sales taxes in existence at subordinate levels of government.

From the purely administrative efficiency point of view there is little doubt that the best solution would be a revenue sharing formula on the Austria–Germany lines, where the retail sales tax at the subordinate level would be abolished and this is the preferred solution of the Canadian Government. However, this solution does limit local accountability and the Canadian Government recognizes that it may not be possible to sell it to the provinces. If a federal VAT were to be adopted in the United States, one imagines that the difficulties of persuading the states to forego their automony to fix the rates and base of a general consumption tax would be even greater. Theoretically, it may be argued that consumption taxes are not an ideal vehicle for local Government autonomy (because substantial differences in rates and base will encourage distortive cross-border shopping), but if, as in Canada and the United States, such taxes exist and cannot be abolished, the search becomes one for second or third-best solutions. Probably, again from the point of view of administrative efficiency, the second best solution would be to persuade the subordinate levels of Government to replace their RST by VAT and have assessment and collections administered by one set of officials – the Canadian Government's second choice. A third-best solution, which takes into account a scenario in which may well occur in the United States, if the Bush administration introduces a federal VAT and the states prefer not to change their RST, is to co-ordinate the assessment/collection process of the federal income taxes and the federal VAT, presumably by the Internal Revenue Service (coordination of income tax and VAT administration is evidently rational whatever solution is adopted and in unitary as well as federal countries).

G. Conclusions

This brief summary of a large portion of the OECD report on consumption taxation has shown that a number of important and often conflicting policy objectives are involved. If the priority is for a simple and efficient consumption tax system, undesired distributional results may follow and even though there are means of remedying them through the tax/transfer payment systems, it may not in practice be possible to do so. If, on the other hand, a more equitable system is preferred, this may consequently entail heavy distortions and higher administrative costs. The variety of consumption tax systems at present in force in OECD countries illustrate that Governments have attached very different weights to these considerations in the past and that it is not easy to accommodate changing preferences.

The authors of this article appreciate the political and economic constraints on Governments having multi-rates and a limited base from following the income tax trend of rate flattening and base broadening, especially if they are members of the European Community, whose Commission's proposals impose additional difficulties in adopting such a system. But for countries without these constraints possibly considering the adoption of VAT (e.g. Canada and the United States), our recommendation would be that cost/benefit trade-off firmly points to the route normally followed by the Scandinavian countries and by New Zealand of a single rate and the widest practicable base, any undesirable redistributional consequences being offset by increased social transfers or non-wastable credits through the income tax system, while we recognize that this is usually much more easily achievable in smaller countries, where decisions on taxes and spending can be more easily integrated. We would also recommend that the administration of VAT be integrated with that of personal and corporate income taxes as is done, for example, in France, Germany and New Zealand, since this reduces the administrative costs of Governments and the compliance costs of the private sector, as well as improving control of tax evasion.

In conclusion, and on a more general level, the authors have little sympathy with advocates of a direct expenditure tax who claim that income from savings is over-taxed or doubly taxed. If additional income is generated from savings it would seem as appropriate to tax such income as it is to tax consumption. A direct expenditure tax (supplemented by a cash flow corporation tax and a tax on bequests) neatly tries to encourage savings while preserving redistributional objectives but would pose all kinds of practical problems such as transitional complications, defining the scope of the savings to be deducted, control of aged emigrants who would escape the bequest tax and renegoti-

14. Of the other OECD Federal countries, the VAT receipts in Austria and Germany are shared between the federal Government and subordinate levels of Government.

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ation of double tax treaties with countries without such a tax. More importantly, such a tax seems superfluous and like "optimal taxation", but unlike VAT, seems an academic blind alley for practitioners. It seems to us rational to diversify revenue sources by taxing both the income and expenditures of taxpayers, and ideally by getting as near as is practicable and politically possible to a comprehensive income tax and to a VAT which covers all goods and services at a uniform rate. Evidently, how nearly this is possible, as well as the level chosen and the relative mix between these 2 taxes would vary from country to country according to their traditions and their current preferences.

Conference Diary

JUNE 1989

Taxation of Branches and Subsidiaries. Brussels, 1-2 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Inspelen op Oort – Een nieuwe fiscale strategie voor (on)belaste vergoedingen en aftrekmogelijkheden. Amsterdam, 5 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Fundamental Elements of U.S. Federal Taxation; U.S. Taxation of Corporate Reorganizations; U.S./International Taxation: Tax Strategies for Cross Border Activities. London, 5-10 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Uitstel van winstneming. Garderen, 8-9 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Anti-Avoidance and Tax Treaty Policies and Practice in the Asian-Pacific Region. Wellington, 9-12 June (English):
Conference Manager, Anti-avoidance Tax Policies in Asia and the Pacific, Institute of Policy Studies, Victoria University of Wellington, P.O. Box 600, Wellington, New Zealand.

Wet Ketenaansprakelijkheid. Amsterdam, 12 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

1989 Corporate Management Tax Conference. Toronto, 12-13 June (English):
Conference Secretary, Canadian Tax Foundation, 130 Adelaide St.W., Ste. 1900, Toronto, Canada M5H 3P5.

Werken met de Nieuwe Invorderingswet. Nieuwegein, 13 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Jersey – A Responsible Offshore Centre. St. Helier, 13-14 June (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants, United Kingdom NN17 1PL.

Strittige Fragen aus der Prüfung von Auslandsbeziehungen – Praktikerseminar. Bonn-Bad Godesberg, 14 June (German):
BS-Gesellschaft für Unternehmerinformation mbH, Mecklenburger Strasse 5, Postfach 240124, 5300 Bonn 2, Federal Republic of Germany.

Expatriate Assignments to the United Kingdom. London, 14 June (English):
Ms. Astrid Hopp, Meetings Secretary, Employment Conditions Abroad Ltd., Anchor House, 15 Britten Street, London SW3 3TY, United Kingdom.

The Use of Tax Havens and Low Tax Finance Centres. Geneva, 15-16 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

International Tax Planning – The Use of Tax Havens and Low Tax Finance Centres. Geneva, 15-16 June (English):
Carys Pugh Roberts or Elaine Hendry, Legal Studies and Services Ltd., 56 Holborn Viaduct, London EC1A 2EX, U.K. Telephone (1) 236-4080.

Starting Business in Japan. Brussels, 26-27 June (English):
Customer Service Department, Management Centre Europe, Postbus 95, NL–3417 ZH Montfoort, The Netherlands.

1989 Offshore Investment Convention & Exhibition. London, 27-29 June (English):
The Offshore Investment Convention Secretariat, Thomas Reed Publications Limited, 80 Coombe Road, New Malden, Surrey KT3 4QS, United Kingdom.

SEPTEMBER 1989

Joint Seminar of the U.S. and British Branches of I.F.A. prior to the RIO Congress. Coral Gables. Miami, 7-8 September (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

I.T.P.A. Workshop. Monte-Carlo, 14-15 September (English):
To: Elisabeth Walters, Conference Director, International Tax Planning Association, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

43rd IFA Congress: Rio de Janeiro, Brazil, 15 September 1989.
Subject I: Disregarding a Legal Entity for Tax Purposes.
Subject II: Administrative and Compliance Costs of Taxation.
Seminar A: Taxation of Services as Rendered Internationally as Opposed to Technical Assistance or Industrial Licence Agreements.
Seminar B: Tax Treaties and Domestic Legislation.
Seminar C: Turnkey Jobs.
Seminar D: Taxation Systems of the South American Common Market.

Fundamental Elements of U.S. Federal Taxation; U.S. / International Taxation; U.S. Individual / Expatriate Taxation. Lésigny, 18-23 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London, WIM 5FT, United Kingdom.

Praktiker-Seminar zur Steuerreform 1990. Wiesbaden, 22 September; Stuttgart, 23 September; München, 29 September; Würzburg, 30 September (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

NOVEMBER 1989

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

DECEMBER 1989

Fundamental Elements of U.S. Federal Taxation. U.S. / International Taxation: Tax Strategies for Cross Border Activities; U.S. Taxation: Oil and Gas – Including International Aspects. United Kingdom, 4-9 December (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, U.K. Telephone (1) 935 7502, telefax (1) 935 1308.

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HONG KONG:

Budget 1989/1990: Predictable and Boring

Ian Harris

Mr. Harris is Group Tax Adviser of the Hongkong and Shanghai Banking Corporation.

Predictable and boring was how one leading commentator described the Budget presented by the Financial Secretary, the Hon. Piers Jacobs, to the Hong Kong Legislative Council on Wednesday, 1 March 1989. However, although that might appear at first sight to be unkind, this probably was in fact the message that the Financial Secretary was attempting to convey in his 1½ hour speech on the current state of the finances of Hong Kong. In his opening remarks he stressed that there was an ever-increasing need from the community for higher quality services but this had to be seen against an inflationary background which had reached 7.5% in the current financial year and was expected to increase further to 8.5% in 1989/1990. The Financial Secretary said, therefore, that there were 3 factors that he had to take into account in preparing his 1989/90 Budget:

(1) inflation,
(2) accumulation of substantial Budget surpluses; and
(3) the need to embark upon a major programme of infrastructural works to enable Hong Kong to develop into the 1990s and beyond.

INFLATION

Although traditionally the main cause of Hong Kong's inflation has been imported because the bulk of Hong Kong's needs are in fact imported, this year the main cause has been Hong Kong's own success as demand for resources, particularly labour, has outstripped supply. This has been translated into higher wages and higher costs of production.

The Financial Secretary referred in particular to China's rate of inflation which is running considerably ahead of Hong Kong's rate because a major proportion of Hong Kong's food and consumer goods are now imported from China. However, it is estimated the import prices of goods from China have increased only by about 1.5% during 1988 and it is felt that China's inflation rate does not materially impact on Hong Kong's rate at the present time. In attempting to cure inflation, Mr. Jacobs said that it was important to control the money supply through the interest rate mechanism and to this extent the recent trend in U.S. dollar rates which Hong Kong have traditionally followed in recent years particularly since the local unit has been pegged against the U.S. dollar have helped in the battle against inflation. The Financial Secretary was of the view that little could be done on the fiscal side as he thought it was important to ensure that the Government's policies on this side do not exacerbate inflation.

BUDGET SURPLUSES

While there was a forecast surplus for the year 1988/89 of HK$ 5.5 billion, the final out-turn for the year is expected to exceed HK$ 14 billion and if recent years are any guide, even this is likely to be exceeded. The main reason for the better than forecast surplus has been the exceptionally buoyant revenue from direct taxes.

INFRASTRUCTURE

The largest work to be undertaken in the future by the Government is a replacement for the existing airport at Kai Tak. Air travel has continued to increase rapidly and despite substantial improvements to the terminal building, the single runway is restricting the number of flights that the airport can physically handle in a day even though more and more flights are undertaken by wide-bodied aircraft. It is predicted that saturation point will soon be reached and it is very clear that the new airport will be required within the next 10 years which will involve a substantial amount of Government expenditure.

With the general expectations of the community, there is also to be continued substantial expenditure on hospitals and other social services and despite continued restriction on the use of motor vehicles, additional expenditure on road is envisaged.

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THE ECONOMY

After double digit growth in recent years the economy slowed down to 7.5% in real terms in 1988. Contrary to predictions the economy escaped largely the impact of the stock market crash in 1987 and business confidence returned at the beginning of 1988. The major constraint on the growth during the year was in the labour market where the unemployment rate fell to a record low of 1.3% in the latter part of 1988 and pressure was growing for the importation of labour particularly for the construction industry. There was an increase in exports of 11% and re-exports of 50% while imports increased by 31% giving a visible trade deficit of HK$ 8 billion.

ECONOMIC PROSPECTS FOR 1989

The momentum of 1988 is expected to carry through at least into the first half of 1989 and although there are likely to be changes in the pattern of exports with those to the United States perhaps increasing while those to the Federal Republic of Germany are expected to remain sluggish. Trade with the People's Republic of China is also expected to increase to give an overall growth in 1989 of 7% in domestic exports and 22% in re-exports. The out-turn of this is expected to be an overall trade deficit for 1989 of HK$ 12.6 billion. However, this is a reflection of the growth in the economy. The GDP in current price terms is expected to rise to US$ 11,000 during the year, an increase of 14.3% in money terms or 4.8% in real terms.

MONETARY ISSUES

The Financial Secretary once again reiterated the advantages of a stable exchange rate which has been achieved mainly by pegging the Hong Kong dollar to the U.S. dollar, and through new accounting arrangements introduced last year the Government have been able to intervene in the market to influence it when the peg has been under pressure. However, as a further development the Financial Secretary announced the development of a programme for the issue of short-term exchange fund bills. These bills will constitute direct unsecured, unconditional and general obligations of the Government for the account of the exchange fund. Given that these bills will be used for monetary purposes, and for the account of the exchange fund, they will not be used for general revenue as often is the case with such instruments elsewhere in the world. Thus these bills will not be used for the purposes of financing deficits or for general expenditure, and will not, therefore, exacerbate the current problem of inflation but will enable the Government to further regulate the monetary market.

EXPENDITURE ESTIMATES

Although expenditure in 1988/89 exceeded forecast by some 2%, this was mainly attributable to pay rises for the disciplined services in the Government. The Financial Secretary did, however, express concern regarding the growth in the public sector, and said that this would be closely monitored in the future although he accepted that further increases in the disciplined services will need to be made in connection with the gradual takeover from the British Forces Garrison by the police. He also expected increases in staffing brought about by further major hospitals at present under construction coming onstream.

FUNDS

A comparatively recent innovation in Government accounting has been the establishment of various funds as a way of earmarking reserves now for capital projects particularly of a long-term nature. Thus, in the forecast of expenditure for 1989/90 provision is made for transfers to funds totalling HK$ 17.7 billion (nearly 3 times the amount transferred in 1988/89) of which HK$ 10.7 billion will be transferred to existing funds and to maintain their value in real terms while a further HK$ 7 billion will be transferred to the Development Loan Fund for new major infrastructural projects.

REVENUE

Although the revenue for 1989/90 considerably exceeded forecast, there are indications that attempts have been made to defer certain items of Government revenue in the current year. This trend is not expected to continue at the same buoyant rate as in 1988/89. The Financial Secretary did, however, return to a topic that he has raised on a number of occasions in the past few years and that is the question of a more stable basis of taxation, in particular a form of sales tax at the wholesale level. He pointed out that the ratio of direct and indirect tax was expected to increase from 62% in the current year to 65% in the next financial year and in his view this was undesirable. To this end, he announced that the Government was preparing a consultative document which he expected to issue for restricted discussion towards the middle of this year. A wider consultative document will be issued once the technical aspects of the first document have been considered. He reiterated the criteria which this new tax should achieve:

(a) it should produce a stable and worthwhile yield at a low rate of tax;
(b) it should cause minimum distortion to the economy; and
(c) it should be simple and cheap to administer.

GOVERNMENT RESERVES

These now stand at some HK$ 50 billion and are expected to rise to some HK$ 71 billion by the end of 1989/90. However, in terms of Government expenditure, the reserves are expected to drop from 91% to 87% in the period to 1992/93 although in real terms

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the level will be maintained. The Financial Secretary declined to give guidelines on what level of reserves is considered appropriate. He did, however, stress that a considerable requirement for capital works is expected in the future and therefore his 'pot of gold' as he called it cannot be regarded in this context as available to be spent regardless.

ESTIMATES OF EXPENDITURE

Expenditure is forecast to rise to HK$ 70 billion which is a 19% increase over the revised estimate for 1988/89. This figure includes transfers to funds expenditure from which is expected to total HK$ 16.8 million. Included in the estimated expenditure is a total of HK$ 4.3 billion for additional unforeseen items.

ESTIMATES OF REVENUE

Revenue was estimated to be HK$ 73.4 billion before the fiscal measures which are detailed below, an increase of 13% over 1988/89. Direct taxation is again expected to be particularly buoyant with a forecast 18% increase in yield over 1988/89 and this will represent 65% of the total direct and indirect taxes compared with 62% and 60% for the previous 2 years. The Financial Secretary drew attention to this fact in relation to his sales tax proposals. Mr. Jacobs proposed therefore increased taxes to the extent of HK$ 550 million mainly to keep in line with inflation and tax concessions totalling HK$ 1.1 billion thus reducing his estimated Budget surplus for 1988/90 from HK$ 3.4 billion to HK$ 2.8 billion.

REVENUE MEASURES

The Revenue measures proposed by the Financial Secretary can be classed under 3 headings:
Indirect taxes
Direct taxes
Legislative proposals

1. Indirect taxes

The proposals under this heading were mainly to keep existing yields broadly in line with inflation:

(a) *Imported hydrocarbons*

An increase of approximately 8% in the duty rate on imported hydrocarbon oil is proposed as follows:

	New rate Per litre	Old rate Per litre	Increase Per litre
Motor spirit	HK$ 2.75	HK$ 2.55	HK$ 0.20
Diesel oil	HK$ 1.37	HK$ 1.27	HK$ 0.10

There will be no change to the HK$ 0.65 per litre refund on diesel oil to franchised bus companies.

(b) *Intoxicating liquor and imported alcohol*

Five changes are to be made to the duty rates on intoxicating liquor and imported alcohol as follows:

- The duty on beer will, in the future, be calculated solely on the volume of beer released from a local brewery or imported. The duty rate will be HK$ 2.20 per litre.
- The specific duty element on cider and perry, champagne and sparkling wines, still wines, non-European type wines and Chinese-type spirits will be increased by 8%.
- The basic rates for imported ethyl alcohol and methyl alcohol will be increased by HK$ 0.35 per litre from HK$ 4.55 to HK$ 4.90 per litre.
- The specific duty rate on liqueurs, whisky, gin, rum, vodka and all other spirituous liquors except brandy will be increased by HK$ 4 per litre from HK$ 48 to HK$ 52.
- The specific duty rate on brandy will be reduced by HK$ 3 per litre from HK$ 55 to HK$ 52 per litre so as to eliminate the differential between brandy and other spirituous liquors.

(c) *Tobacco*

The duty rates on tobacco are to be increased as follows:

	New rate (HK$)	Old rate (HK$)	Increase (HK$)	Increase (%)
Smoking tobacco	2300/kg	212.00/kg	18.00/kg	8.49
Chinese prepared tobacco	50/kg	45.50/kg	4.50/kg	9.89
Cigars	250/kg	233.00/kg	17.00/kg	7.30
Cigarettes	190/1000	175/1000	15/1000	8.57

(d) *Fees and charges*

The business registration fee will be increased by HK$ 80 from HK$ 550 to HK$ 630. The HK$ 100 levy for the Protection of Wages on Insolvency Fund remains unchanged.

Vehicle and driving licence fees will be increased by approximately 8%.

Deposit taking company licence and registration fees together with related fees will be increased by 15%.

Later this year, a new vessel traffic management system for the port will be commissioned. To partly defray the cost of installing and operating the new system, the passenger embarkation fee for passengers departing from the Macau and China Ferry Terminals will be increased by HK$ 2 from HK$ 15 to HK$ 17. Port and light dues will also be increased at the same time.

During 1989, a number of other fees are scheduled for their normal review including those relating to water charges.

2. Direct taxes

The Financial Secretary reduced the standard rates by 0.5% as follows:

	New rate	Old rate
Corporations	16.5%	17%
Others including property tax	15%	15.5%

The following adjustments were proposed in respect of personal allowances as follows:

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	New rate (HK$)	Old rate (HK$)
Personal allowance		
Basic	32,000	29,000
Additional	7,000	7,000
Married allowance		
Basic	66,000	60,000
Additional	14,000	14,000
Working wife	15,000	15,000
First child allowance	13,000	12,000
Second child allowance	9,000	8,500
Dependent parent (each parent)		
residing with taxpayer	14,000	13,000
not residing with taxpayer	11,000	10,000
Single parent child allowance	20,000	—

Single parent child allowance is a new allowance designed for single parent families maintaining children and is an addition to the personal allowance.

3. Legislative changes

(a) *Interest tax*

The Financial Secretary proposes to abolish interest tax as from 1 April 1989; it should be noted, however, that this abolition will not affect entities carrying on business in Hong Kong where liability to tax on interest falls within profits tax. At present liability to interest tax only falls to interest paid by non-financial institutions in Hong Kong.

(b) *Initial allowance*

The Financial Secretary proposes to increase initial allowance on qualifying plant and machinery from 55% to 60%.

(c) *Stamp duty*

The Financial Secretary proposes to introduce legislation to eliminate stamp duty on the lending and borrowing of share script used as a means of settling stock exchange transactions.

(d) *Taxation of married women*

Work is continuing on drafting this legislation which is expected to be introduced in Bill form later in the current year with an intended commencement date from 1 April 1990.

(e) *Unit trust and mutual funds*

Calls have been made for an amendment to the liability to profits tax on unit trusts and mutual funds. Consultation is taking place with interested parties.

(f) *Shipping*

In view of the provisions of the United States Tax Reform Act 1986 regarding foreign shipowners, the Governments of Hong Kong and the United States are in consultation regarding a reciprocal tax exemption concerning income derived from international operation of ships. A further announcement is expected shortly.

(g) *Venture capital*

In view of the interest in the use of venture capital and the uncertainty as to the treatment for profits tax purposes, the Government is looking into the question to ascertain whether a concession would be desirable and practical.

CONCLUSION

With the Government facing a major political change in under 10 years and at the same time facing demands for considerable capital expenditure from a narrow tax base, it is probably not surprising the Financial Secretary chose to introduce a cautious Budget. The wisdom of this course of action will not be apparent until this time next year.

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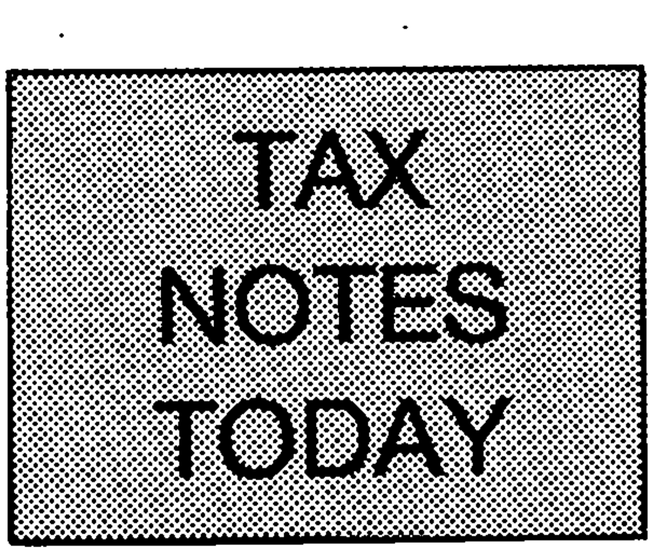

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HONG KONG:

A Supply-side Budget

Y.C. Jao

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Hong Kong's Budget for the fiscal year 1989/90, presented by the Financial Secretary, Mr. Piers Jacobs, is notable for its huge surplus and various tax concessions. This article outlines the Budget proposals and appraises their significance.

I. ECONOMIC AND FISCAL BACKGROUND

Before 1982, Hong Kong was noted for its general trend of annual fiscal surpluses, with only rare exceptions. In 1982, however, Hong Kong was simultaneously hit by economic downturn and the announcement by the People's Republic of China (PRC) that it intended to resume sovereignty over the entire Hong Kong area in 1997, when the United Kingdom's lease on the New Territories expires. The protracted and sometimes acrimonious negotiations between the PRC and the United Kingdom during 1982/84 over the future of Hong Kong triggered off a profound confidence crisis which manifested itself in an unprecedented combination of currency crisis, banking crisis and fiscal crisis.[1] As far as the fiscal crisis was concerned, the sharp fall in prices on the asset markets (the land auction market, real property market and stock market) caused a corresponding sharp decline in Government revenue, especially land sales. As a result, there were 3 consecutive years of fiscal deficit in 1982/85, which forced the Government to run down its fiscal reserves, and raise the standard tax rate from 15% to 17%, and corporation profits tax from 16.5% to 18.5%, in 1984. At the same time, the Government also issued 5-year bonds totalling HK$ 1,000 million.[2]

Two events saved Hong Kong from total collapse in those critical years. One was the establishment of the "linked exchange rate system" in October 1983, under which Hong Kong's legal tender notes were to be backed 100% by U.S. dollars, and the exchange rate was fixed at US$1 = HK$ 7.8. This system quickly stabilized the exchange rate against the U.S. dollar and restored confidence in the monetary system.

The other event was the signing of the Sino-British Joint Declaration in December 1984, under which the United Kingdom agreed to transfer sovereignty over the entire Hong Kong area to the PRC on 1 July 1997, and the PRC undertook to preserve the existing economic and social system of Hong Kong unchanged for 50 years after 1997. While political uncertainty over the future of Hong Kong has by no means vanished because so much depends on the PRC's goodwill and performance, the panic that gripped Hong Kong in 1982/84 has gradually subsided as the agreement commits both powers to the maintenance of Hong Kong's stability and prosperity. Moreover, the agreement has also been endorsed by other major powers such as the United States, Japan and the European Community.

Economic recovery in the United States and elsewhere since 1982 (while often erratic and uneven), has also helped an export-oriented economy such as Hong Kong's. The growth rate of Hong Kong's Gross Domestic Product (GDP) accelerated from 3% in 1982 to 9.5% in 1984. Although this growth rate plummeted to 0.1% in 1985 due to temporary loss of competitiveness and sluggish export market conditions, it soared to 11.9% in 1986 and 13.8% in 1987. In 1988 it again slowed down to 7.4%. However, over the period 1982/88, the annual growth rate in real terms still averaged a respectable 7.4%, only slightly lower than the long-term trend growth rate of 8%.

Against the background of economic upturn, Hong Kong's asset markets, particularly the property market, have also recovered. Property prices have generally trebled since 1984. The Hang Seng index of stock prices rose from about 1,000 just before the initialling of the Sino-British agreement in September 1984 to nearly 4,000 just before the global crash of October 1987, when it fell to around 2,000 at one point. Since then, it has gradually risen to about 3,050 as of mid-March 1989.

The recovery of the economy and the asset markets has in turn caused buoyancy in Government revenue, not only in respect of personal and company taxation,

1. See Y.C. Jao, "The 1997 Issue and Hong Kong's Financial Crisis", *Journal of Chinese Studies,* Vol. 2 No. 1 (April 1985) at 113-54.
2. For previous reviews of Hong Kong's Budgets, see Y.C. Jao, "Hong Kong 1983-84 Budget: Tax Proposals", 37 *Bulletin for International Fiscal Documentation* 6 (1983) at 265; Y.C. Jao, "Hong Kong's New Revenue Proposals and Their Implications", 38 *Bulletin for International Fiscal Documentation* 7 (1984) at 298; Y.C. Jao, "Hong Kong: Return to Balanced Budget", 40 *Bulletin for International Fiscal Documentation* 7 (1986) at 326.

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but also in respect of other non-tax revenues such as land sales and stamp duty. Consequently, after 3 years of deficit, Hong Kong has re-entered an arena of chronic surplus since the fiscal year 1985/86.

For 1989, the growth rate of the real GDP is expected to slow down to 6%. However, inflation, as measured by the consumer price index, accelerated over the years from 2.8% in 1986 to 7.5% in 1988 and is expected to rise further to 8.5% in 1989. The unemployment rate, on the other hand, fell steadily from 4.5% in 1983 to only 1.4% in 1988. Indeed, during the past 2 years, Hong Kong has been facing an acute labour shortage. Clearly, the economy has been in a state of overheating for some time.

II. BUDGET PROPOSALS

It is against this economic and fiscal background that the budget for 1989/90 was presented. The Government's budgetary strategy was constrained by 2 conflicting considerations. On the one hand, the inflationary pressures called for tighter fiscal policy or a larger planned fiscal surplus. On the other hand, the larger than expected realized surpluses during the past 2 years have strengthened popular demand for more generous tax concessions. At the same time, economic and population growth by themselves generate increasing demand for the expansion and improvement of infrastructure and public services, all of which necessitate higher Government expenditure. Inevitably, the Budget represented a pragmatic compromise between conflicting objectives.

A. Planned expenditure and revenue

The draft estimates of expenditure and revenue, after taking into account transfers to various earmarked funds, are HK$ 69 billion and HK$ 82.2 billion, respectively, which are 19.5% and 12.8% higher, respectively, in nominal terms than the revised estimates of the previous fiscal year.[3] After adjusting for tax concessions (described below), the fiscal surplus is estimated at about HK$ 11.5 billion.

B. Tax concessions

The standard rate of tax (which under Hong Kong's schedular system applies to such taxes as unincorporated business profits tax, salaries tax, property tax, interest tax and personal assessment) and the corporation profits tax are both reduced by 0.5% to 15% and 16.5%, respectively. The interest withholding tax is completely abolished.

The basic personal allowance is increased from HK$ 29,000 to HK$ 32,000 for a single person and from HK$ 60,000 to HK$ 66,000 for a married couple. Taken together, the new basic allowance plus the existing additional personal allowance (HK$ 7,000 for single persons and HK$ 14,000 for married couples) will total HK$ 39,000 for single persons and HK$ 80,000 for married couples. In addition, the child allowance is increased for the first child, from HK$ 12,000 to HK$ 13,000, and for the second child, from HK$ 8,500 to HK$ 9,000. The allowance for a dependent parent is increased from HK$ 10,000 to HK$ 11,000, while the total allowance in respect of a dependent parent who resides with a taxpayer will now be HK$ 14,000. Finally, a new allowance of HK$ 20,000 is provided for widows or single parents who are solely or predominantly responsible for the care of dependent children.

The initial allowance for expenditure on qualifying machinery and equipment is increased from 55% to 60% to encourage capital formation in the industrial sector. Finally, to facilitate settlement of transactions on the stock exchange, stamp duty is exempted for the lending and borrowing of share scripts.

C. Adjustments of duties and fees

The duties on certain commodities and other fees and charges have been adjusted from time to time in accordance with 2 principles: to maintain revenue in real terms and to recover the costs of public services. The Budget for 1989/90 proposes to increase duties on hydrocarbon oil, liquor and tobacco, business registration fees, vehicle and driving licence fees, deposit-taking licence and registration fees, and port-related fees, by 8%-15%.[4]

D. Other fiscal and monetary measures

It is disclosed in the Budget that a sales tax at the wholesale level is being contemplated by the Government in order to achieve a wider and more stable tax base. A consultative paper on this subject will be released later in the year. Other fiscal matters under consideration are the separate taxation of married women, exemption of unit trusts and mutual funds from profits tax, and a tax concession for venture capital. Negotiations are also being held with the U.S. Government for reciprocal exemption of tax on income derived from international shipping operations.

In respect of monetary matters, the Government is considering the issuance of Exchange Fund Bills to

3. The Hong Kong Government's accounts can be quite confusing and misleading to the uninitiated, not only because of the way they are presented, but also because of the discretionary manner in which the Financial Secretary can shift funds from one account to another. Briefly, the General Revenue Account covers both current and capital expenditure and revenue. Then there are various earmarked funds, i.e. Capital Works Reserve Fund, Development Loan Fund, Mass Transit Fund and Student Loan Fund. The Home Ownership Fund was transferred to the Housing Authority on 1 April 1988. The accounts presented in the Budget are usually the General Revenue Accounts plus the funds. Finally, the Consolidated Account comprises the General Revenue Account, the earmarked funds, as well as expenditure and revenue of other public bodies such as the Housing Authority, The Urban Council and the Regional Council. For a more detailed analysis, see H.C.Y. Ho, "Public Finance", in H.C.Y. Ho and L.C. Chau (eds.), *The Economic System of Hong Kong* (Hong Kong: Asian Research Service, 1988), Chapter 3.

4. For details, see *The 1989-90 Budget: Speech by the Financial Secretary*, (Hong Kong: Government Printer, 1 March 1989), Appendix F.

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serve as a monetary policy instrument (but not as a fiscal policy instrument as is the case with Treasury Bills elsewhere).[5] This is the sequel to a package of monetary measures, known as New Accounting Arrangements, introduced in July 1988, under which the territory's largest commercial bank and de facto quasi-Central Bank, the Hong Kong and Shanghai Banking Corporation, is required to maintain a clearing account with the Government-owned Exchange Fund. As a result, the monetary authorities can now exercise more effective control of inter-bank liquidity.[6] The proposed Exchange Fund bills will add one more instrument for influencing money market conditions.

III. EVALUATION

Hong Kong's fiscal policy in recent years has been notable for several achievements. First, the standard tax rate and the corporation profits tax have been successively cut 3 times (0.5% in 1987/88, 1% in 1988/89 and 0.5% in 1989/90). As a result, the direct income tax rates have now fallen to the pre-1984 level. Indeed, had there been no inflationary threat, the tax cut in the 1989/90 fiscal year would probably have been more generous. By these actions, the Government has sent out a clear message about its determination to maintain Hong Kong's reputation as a low-tax territory. Second, these tax cuts have been accompanied, not by growing fiscal deficits, but by sizeable fiscal surpluses. These surpluses have enabled Hong Kong to rebuild its fiscal reserve, depleted during the fiscal crisis of 1982/84, to HK$ 60 billion at the end of the 1988/89 fiscal year; this is expected to rise further to about HK$ 71 billion at the end of the 1989/90 fiscal year. At the same time, however, Government expenditure has grown at a sufficiently high rate to finance the continuing expansion and improvement of infrastructure and public services, especially health education and social welfare. Third, despite the high growth rate of Government expenditure, the size of the public sector, as measured by the ratio of expenditure on Consolidated Account to Gross Domestic Product, is no more than 16.4% in 1989/90, which is actually lower than that in the late seventies and early eighties. Thus the risks of "crowding out" and allocational inefficiency are relatively low in Hong Kong. Fourth, the total abolition of interest withholding tax and the exemption of the lending and borrowing of share scrips (a standard practice in international stock exchanges) will encourage the development of the capital market in Hong Kong. Together with the tax cuts, these measures strengthen Hong Kong's position as an international financial centre, particularly in the Asian-Pacific region, in the face of growing competition from Tokyo and Singapore.[7] Fifth, the increased capital allowance will stimulate capital formation and will facilitate Hong Kong's transition to a more capital-incentive growth path. In short, Hong Kong has been pursuing, without any fanfare, a supply-side policy with remarkable success.

This is not to suggest that the 1989/90 Budget is flawless. The Government's attitude toward inflation has been widely criticized for being too complacent. For example, it chooses to use Consumer Price Index A to measure inflation, estimated to be 8.5% in 1989.[8] This seriously underestimates the true level of inflation. The Government's own Gross Domestic Product deflator reveals that the inflation rate for 1989 will be 9%. However, neither the CPI nor the GDP deflator is an ideal price index, because both omit asset prices.[9] If asset prices, especially those of real property, were included, Hong Kong's true inflation rate would definitely be in the double-digit range. The Government also pins its hope on the cyclical downturn as a means of tackling the inflation problem. It ignores the fact that the linked exchange rate system, which pegs the Hong Kong dollar to the U.S. dollar at 7.8, may have been the root cause of the current acceleration of inflation since it now seriously undervalues the Hong Kong dollar. However, the Government insists that the peg cannot be altered. In regard to the acute labour shortage, the Government refuses to consider even selective importation of foreign labour for critically affected sectors such as construction and manufacturing.

There are also some disturbing trends in the public sector. First, the growth rate of public expenditure for 1989/90, at 9% in real terms, exceeds the trend growth rate in real terms of the economy at 6%. This violates the Government's own guideline that the real growth rate of expenditure should be held below that of the economy. Second, the growth rate of the civil service, at 3.9%, also exceeds the Government's target rate of 2.5%. Third, current revenue is overly dependent on direct taxes which are highly sensitive to cyclical fluctuations. The rectification of this weakness through the introduction of a broadly based sales tax will be the subject of a forthcoming Government consultative paper.

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5. Readers might wonder why monetary matters are also included in the Budget. This is because, in Hong Kong's governmental hierarchy, the Financial Secretary is an extremely powerful official who combines the powers and functions of the Ministry of Finance/Treasury Secretary and the Head of the Central Bank.

6. For a detailed discussion of the new system, see J.G. Greenwood, "Intervention Replaces Arbitrage – The July Package of Monetary Measures", *Asian Monetary Monitor* (November-December 1988) at 1-6; Y.K. Ho, "The New Clearing System – A Monumental Change in the Management of the Hong Kong Financial System", *The Securities Bulletin,* No. 28 (August 1988) at 24-30.

7. In 1986, the Chinese Banks' Association of Hong Kong formed a Study Group and invited the present writer to serve as its convenor. Its report, released in May 1988, recommends, *inter alia,* tax cuts to the pre-1984 levels and other tax incentives for money market instruments in order to foster Hong Kong's status as a financial centre. See Y.C. Jao (Ed.), *Hong Kong's Banking System in Transition: Problems, Prospects and Prospects* (Hong Kong: Chinese Banks' Association, 1988), Chapters VII and IX.

8. There are 3 consumer price indexes in Hong Kong. CPI (A) is based on the spending behaviour of households whose monthly expenditures ranges between HK$ 2,000 and HK$ 6,499. CPI (B) is based on that of households whose monthly expenditure ranges between HK$ 6,500 and HK$ 9,999. Finally, the Hang Seng CPI is based on those households whose monthly expenditure ranges between HK$ 10,000 and HK$ 24,999.

9. For a fundamental critique, see A.A. Alcian and B. Klein, "On a Correct Measure of Inflation", *Journal of Money Credit and Banking,* Vol. 5 (1973) at 173-91.

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INDIA:

Budget 1989/90: Fiscal Juggling?

Kailash C. Khanna

Yet, another Finance Minister, the fourth in Mr. Rajiv Gandhi's first 5-year term of office, presented the Indian Union Budget for the fiscal year 1989/90 on 28 February 1989. Apparently, the new incumbent, Mr. S.B. Chavan, was given a difficult mandate; this being the last year of the present Government and an election year, his Budget proposals had to be framed in a manner which could be seen to make a visible dent in the problems of unemployment and poverty, would mitigate the tax burden on middle income groups and would keep the budgetary deficit within professed limits. In short, the Budget should try to please all. Unfortunately, in attempting to fulfil this mandate, Mr. Chavan has presented a Budget, which, to borrow the words of an eminent economist and a former Finance Minister of West Bengal, "does not try for anything at all". Unlike earlier years, the 1989/90 Budget has not evoked any pertinent comments; it has been generally described as "populist", "political symbolism" and so on. Judged from a fiscal and economic angle, the Budget is a lacklustre exercise.

In Part B of his Budget Speech, the Finance Minister enumerates the objectives to which his Budget proposals are directed. These are (i) promoting productive employment; (ii) protecting the consumption standards of the poor; (iii) discouraging non-essential luxury consumption; (iv) providing some relief to middle income taxpayers; (v) maintaining the tempo of industrial growth; and (vi) containing the Budget deficit for 1989/90.

Taking the last objective first, the aggregate of capital and revenue receipts during the fiscal year 1980/90 is estimated at 748,240 million Rs. Total expenditure, both on capital and revenue accounts, is estimated at 821,610 million Rs., resulting in an overall deficit of 73,370 million Rs. This, no doubt, compares favourably with the last year's Budget deficit of 74,840 million Rs. and the revised estimate of 79,400 million Rs. and the revised estimate of 79,400 million Rs. However, there is a catch to these calculations. The revenue deficit of 70,120 million Rs. has been arrived at by transferring a sum of 23,000 million Rs. (being deposits with the Oil Coordination Committee) from capital account to revenue account. If this was not done, the revenue deficit would be 93,120 million Rs. and there would be a surplus of 19,750 million Rs. in the capital account. Further, there were pre-Budget increases in the controlled prices of coal and steel; an 11% hike in railway freight charges was announced a few days earlier. Thus an aggregate burden of 12,760 million Rs. was imposed shortly before the introduction of the Budget. The extra tax effort in the Budget has been estimated at 12,870 million Rs. If the total impost of 25,630 Rs. is taken into account, the gross estimated deficit will increase substantially. Having regard to the fact that the revised estimate for the year 1988/89 shows an increase of about 12% in the revenue deficit, it is very likely that the final deficit for 1989/90 will end up with a figure much higher than the estimated sum of 73,370 million Rs. Mr. S.B. Chavan's claim of containing the deficit may prove hollow.

Let us now turn to the objective of promoting productive employment. For this purpose, it is intended to introduce a new intensive rural employment programme. In order to mobilize resources for this programme, the Finance Minister proposes to levy a surcharge at the rate of 8% on resident taxpayers with income above 50,000 Rs. from assessment year 1990/91. It is interesting to note the justification for this impost in the Finance Minister's own words: "I am sure that those who are privileged to have employment in a society, where there are so many who are deprived, will not mind this sacrifice in the interest of creating employment for those not so fortunate."

Apart from the fact that the "justification" seems to be in the nature of robbing Peter to pay Paul, there are other basic objections to the levy of the surcharge. In December 1985, the Government announced with much fanfare a long-term fiscal policy. Paragraph 5.5 of the policy statement reads: "Under certain compelling circumstances, such as an external emergency, it may be necessary to mobilise additional revenues through taxation. In such an extraordinary situation, the Government will take recourse to levying a surcharge on income-tax .... Any such surcharge will be a temporary measure."

While a surcharge to meet the exigencies of a drought could perhaps be justified on grounds of "compelling circumstances" created by an act of God, there can be no logical, ethical or credible reason for the imposition of an income tax surcharge for an intended programme to reduce unemployment, despite the Finance Minister's fervent appeal – to "those who are privileged to have employment" – for sacrifice.

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To say this is not to belittle the magnitude of the unemployment problem but to point out certain inherent fallacies in Mr. S.B. Chavan's assumptions. First, the existence of a vast number of unemployed is not due to any "external emergency" or any exploitation by "those who are privileged to have employment". It is a direct consequence of the mismanagement of the country's economy as a result of which agricultural, industrial and economic growth has not kept pace with the increasing number of job-seekers. Secondly, in light of the experience gained from earlier anti-poverty programmes in rural areas, it is strongly apprehended that even a large allocation of funds for a rural employment programme may not guarantee full employment to "at least one member of each family living below the poverty line", as contemplated. It has now been officially admitted that the number of those below the poverty line is still 37.5% of the total population, i.e. around 300 million in absolute numbers. It is very likely that the part of the funds which will ultimately reach the target groups will be disbursed for token or inadequate services. In any case, such funds will not suffice; even earmarking 5,000 million Rs. for 70 million unemployed is too meagre a sum to ensure jobs that will last. The so-called wages may turn out to be more in the nature of a dole than remuneration for work actually done thereby defeating the very objective of creating productive employment.

Thirdly, as stated by the Rt. Hon. Nigel Lawson, the British Chancellor of the Exchequer, in his 1985 Budget Speech, "It cannot be repeated too often that it is business and not governments that create jobs. The government's responsibility is to foster conditions which will encourage business to grow and create more jobs." Dealing specifically with the problem of unemployment in his subsequent year's Budget Speech, the Chancellor reiterated: "I turn now to the continuing problem of high unemployment. It is a problem that can be solved and there is no secret how ..... The first is a sustained improvement in the performance of business and industry, and thus of the economy as a whole ..... In the long run what really matters is the creation of a climate in which business and industry flourish. For it is companies not governments which create jobs."

Admittedly, conditions in India differ from those in the United Kingdom; unlike the latter country, the former has almost 70% of its population dependent on agriculture and about 70 million unemployed in rural areas. Nevertheless, the basic principles remain the same; whether agriculture or industry, congenial conditions must be created for both to flourish. The imperative need in India is the provision of necessary infrastructure in rural areas, together with the requisite raw materials and equipment, to enable the village artisan, craftsman, trader, etc. to engage himself in gainful employment either by himself or in the service of another. Agro-based industries and the establishment of small-scale units in backward and rural areas should receive specific encouragement and assistance so that the rural population can freely carry on its business, trade, profession or vocation. This is the correct approach and not the pursuit of pet schemes of publicity-oriented, politically motivated, programmes of rural employment which may, for many an unemployed, constitute a dream unfulfilled.

Finally, to encourage business and industry to create more jobs, taxes must be reduced, not increased. "Nothing could be further from the truth than the claim that we have a choice between cutting tax and cutting unemployment. The two go hand in hand. It is no accident that the two most successful economies in the world, both overall and specifically in terms of job creation, the U.S.A. and Japan, have the lowest level of tax as a proportion of GDP.", observed the Rt. Hon. Nigel Lawson.

Regrettably, Mr. S.B. Chavan proposes to do quite the reverse by hiking the tax burden both on individuals and companies, barring those with incomes below 50,000 Rs. It is somewhat intriguing that the levy of an 8% surcharge on corporate income has not been referred to anywhere except in the Finance Bill; unfortunately para. 80 of Part B of the Budget Speech has been somewhat ambiguously worded in this respect.

In reality, companies that provide gainful employment are hit the hardest and will contribute a very substantial part of the budgeted receipts of 5,000 million Rs. from the proposed surcharge. The tax rate on domestic companies will go up to 54, 59.40 and 64.80% of taxable profits, depending on the type of the company, from the existing rates of 50, 55 and 60%, exclusive of the drought surcharge. In the case of drought, the rain gods came to our rescue, but unemployment is likely to be a perennial problem and the proposed surcharge will probably stay forever. The company tax rate will again reach a new high and, if the tax on dividends is also taken into account, as it must be, the net return to shareholders will fall considerably. This will discourage equity investment, retard corporate growth and distort expansion plans, thereby defeating the very objective of the unemployment surcharge as job opportunities will decline. Viewed from any angle, the proposed surcharge is ill-conceived and inequitable. The growth, if any, through Government programmes of rural employment will be offset by a fall in industrial employment. The Finance Minister should reconsider the suggested impost, which, in any event, is 60% higher than the drought surcharge which it seeks to replace.

The Budget Speech concedes that house construction is an activity "that is capable of generating a very substantial volume of employment". However, the Finance Minister has confined his suggestion for granting priority to the activity within the framework of the National Housing Policy executed mainly through governmental agencies. House construction can be given a substantial boost if it is classified as an industry and granted fiscal incentives. House construction companies and cooperatives can be set up for building small tenements in rural and backward areas; weighted wages and development costs should be tax-deductible. Likewise, loans to employees granted specifically for house construction should be deducted from the

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employer's taxable income, subject to prescribed conditions; loan recoveries will, of course, form part of the employer's income. The aim should be to increase employment through an acknowledged labour-intensive activity.

While there is no suggestion to increase the existing tax rate of 65% on foreign companies, a new section of the Income Tax Act, Sec. 44BBB (the number itself is an indication of the mess the Act is in), is proposed whereby 10% of the amount paid to foreign companies for specified approved turnkey power projects shall be treated as taxable income. The suggestion violates established canons of income taxation in international law and should be dropped forthwith.

Linked to the foregoing is Mr. S.B. Chavan's objective of maintaining "the tempo of industrial modernisation and growth". It is now universally admitted that the corporate form of business is the ideal vehicle for industrial and commercial growth. However, the proposed increase in corporate tax rates, coupled with the pre-Budget increase in the prices of essential inputs like steel and coal, as well as the hike in railway freights, are bound to have deleterious effect on development as production costs will increase leading to a cost-push economy. There are no cogent suggestions for increased industrial activity nor any bold measures towards higher production.

Although a reference has been made to the operations of the capital markets in Part A of the Budget Speech, no pertinent suggestions have been offered for better and healthier growth of the markets. The limit for non-deduction of tax at source is proposed to be raised to 2,500 Rs. in respect of interest on bonds and debentures. In order to stimulate investment in equities, it is intended to introduce an equity-linked savings scheme whose details will be announced later. These have been dubbed "cosmetic changes" of little relevance and the Budget for 1989/90 has, in fact, left the capital markets high and dry!

The minor tinkering with personal tax rates on the lowest taxable slab of income will not achieve Mr. Chavan's objective of providing some relief to middle income taxpayers. It is proposed to reduce the tax rate from 25% to 20% in the slab of 18,000 Rs. to 25,000 Rs. The relief is too small and will be more than offset by the inflationary trends inherent in the various budgetary suggestions. It is a populist but futile attempt to placate an articulate section of the electorate.

The objective of protecting the consumption standards of the poor is also unlikely to be fulfilled. Apparently there are a few tax exemptions on some "poor man's goods" but to be really meaningful the public distribution system should be substantially extended so as to make cheap foodgrains and other essentials readily available. The intended increase of 5% of current rates of specific excise duty on a wide variety of goods will not leave the poor untouched. The Budget deficit, increased coal and steel prices and higher railway freight will lead to inflationary distortion of real income distribution and will have an adverse effect on the poor.

The consumption of non-essential luxury items is proposed to be discouraged through increases in excise duties on items like automobiles, colour televisions, etc. However, with an affluent section equal in absolute numbers to the population of several highly developed countries (even if it constitutes a very small percentage of India's population) and in possession of vast sums of unaccounted income and wealth, a mere increase in prices through higher taxes cannot curb consumption. Only restricted output of such items can attain the desired results. The expenditure tax for staying in luxury hotels is to be increased from the existing 10% to 20%. Basic fares on domestic air travel are proposed to be raised by 10% and the foreign travel tax will also be increased. The burden will fall mainly on expense account travellers – company executives and senior Government officials; it will have little impact. The suggestions seem to have been prompted more by the desire to portray a "soak the rich" image than on any valid economic ground.

In sum, the 1989/90 Budget is unlikely to improve industrial production, accelerate economic growth, substantially reduce unemployment and sustain prices. However, the text of the Budget Speech and the manner of presentation of the budgetary figures and tax proposals have shown the Finance Minister to be a competent fiscal juggler. The 4 "aces" of taxation on the affluent, namely, surcharge on income tax, doubled expenditure tax, higher air travel fares and costlier luxury goods have been significantly highlighted but heavier imposts in the form of increased excise and prices and inflation, which will hit the poorest of the poor, have been discreetly tucked up his sleeve! Whether these tactics will secure the ruling party the vast number of rural votes, without conferring tangible economic benefits, will be an interesting experience to watch in the elections to be held within the year in the world's largest democracy.

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INDIA:

1989/90 Budget: A Tightrope Walking

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Come February, a number of Government documents relating to the Indian economy are presented to the Parliament. This year the process of unfolding official economic information got underway with the presentation of the Railway Budget on 23 February. The next day the Economic Survey for 1988/89 was tabled in the House. Finally, the Union Budget was presented on 28 February by the Finance Minister Mr. S.B. Chavan.

The various presentations and announcements have wide repercussions for agriculture, industry, trade and services. These documents review the performance of various sectors of the economy, the current economic thinking of the Government, and its priorities and programmes for the coming year. As the elections to the Indian Parliament are due in December 1989, the Budget assumed added significance.

Let us first have a quick look at the present state of the Indian economy. It may be recalled that 1987/88 was a nightmarish year when the country suffered the severest drought of the century. As many as 21 out of 35 rainfall sub-divisions received deficient or scanty rainfall. The foodgrain production declined from 150 million tonnes to 138 million tonnes. Despite the severity of drought, the Government succeeded in limiting the inflation rate to 10%, thanks mainly to the buffer stocks of foodgrains. According to the Economic Survey, industrial production remained buoyant and grew 7.5%. This remarkable performance under adverse conditions is attributed to efficient competition, excellent supporting performance of the power sector (mainly thermal generation) and the general decline in the sensitivity of the industrial sector to fluctuations in agricultural production. The overall performance of the economy turned out to be an increase of 3.6% in real GNP during the drought year. The economy is said to have assumed a kind of resilience rarely seen in a poor developing country.

As if the rain gods were pleased with the acid test, they blessed the country with the best rainfall in living memory this year. Excess or normal rainfall was received almost all over the country. Of the 35 meteorological subdivisions, 32 received excess to normal rains during the south-west monsoon season (June to September 1988). As a consequence, foodgrain production, which declined to about 138 million tonnes last year, is likely to exceed the target of 166 million tonnes set for 1988/89, and may even exceed the 170 million tonnes mark.

The resurgence of agricultural growth and hydroelectric power generation augur well for the industrial sector as well. In addition, the recent policy of liberalization in terms of imports, industrial licensing, price and distribution controls, seems to have paid rich dividends. In furtherance of this policy, the Finance Minister announced in his Budget Speech the complete decontrol of the pricing and distribution of cement and aluminium with effect from 1 March 1989. It is noteworthy that both these industries have made rapid strides in recent years. The production of cement, which stood at 21 million tonnes in 1981/82, is expected to increase to 43 million tonnes in 1988/89 and to 49 million tonnes in 1989/90. The phenomenal growth has not only led to stoppage of imports but opened the possibility of exports. The long-term strategy is to increase the production to 65 million tonnes by the end of the Eighth Plan (1994/95) and to 87 million tonnes by the end of the Ninth Plan (1999/2000). Similarly, aluminium production has rapidly increased after the commissioning of the National Aluminium Company. The record production of 278,000 tonnes in 1987/88 is projected to increase by 30% to about 360,000 tonnes in 1988/89 and by another 20% to reach a level of 435,000 tonnes in 1989/90.

However, there are at least a few grey areas, causing serious concern for the policy makers. Growing trade deficits and dwindling foreign exchange reserves pose formidable challenges to the Government. Imports during 1987/88 totalled 223.9 billion Rs. while exports aggregated only 157.4 billion Rs. during the same period. The expansion of imports is directly linked to the import liberalization policy aimed at boosting investment and modernization of the economy. The surge in the import bill is also due to the imports of foodgrains and edible oils necessitated by last year's unprecedented drought. Another contributing factor is the sharp increase in the international prices of metals, chemicals and edible oils. The debt repayment liabilities are also high. The external debt of the Indian Government is expected to total 252.4 billion Rs. as of 31 March 1989.

The mounting internal debt and the enhanced interest rates paid thereon have multiplied debt servicing liabilities of the Government. The provision for interest payments in the 1989/90 Budget is 170 billion Rs., almost one third of the total revenue receipts (526 billion Rs.) of the Government. It is 40 billion Rs. more than the allocation for defence (130 billion Rs.). The internal debt of the Government is anticipated to reach 1,144 billion Rs. as of 31 March 1989. Experts have warned of an internal debt trap, a situation in which borrowings are necessary in order to keep up with the servicing of the debt.

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Caught between the crossfires of election year and fiscal realism, the budgetary exercise was a tightrope walking for the Finance Minister. By pegging down the defence expenditure and Budget deficit to last year's levels he did show fiscal pragmatism, and by announcing a couple of poverty alleviation and rural employment programmes also served the electoral aspirations of the ruling party. His Budget proposals, in his own words, were oriented to the following ends: "promoting productive employment; protecting the consumption standards of the poor; discouraging non-essential luxury consumption particularly when it is import-intensive; providing some relief to middle income taxpayers; maintaining the tempo of industrial modernization and growth; containing the Budget deficit for 1989/90".

DIRECT TAXES

How are these objectives to be achieved? Let us first turn to his direct tax proposals. It will be recalled that a surcharge at the rate of 5% on incomes above 50,000 Rs. was levied last year to mobilize resources for meeting drought requirements in 1987 and its after-effects in 1988. The Finance Minister withdrew this surcharge but in the same breath imposed another surcharge at the rate of 8% on resident taxpayers with incomes above 50,000 Rs. The new surcharge is meant to mobilize resources for a new employment scheme named after Jawaharlal Nehru, the first Prime Minister and architect of modern India, whose birth centenary celebrations are underway. However, the 10% surcharge on the wealth tax imposed for drought purposes has been withdrawn.

After maintaining stability in the direct tax rates during the last 4 years, the Finance Minister announced a cut in the rate of income tax for individuals in the entry slab of 18,000-25,000 Rs. from the present 25% to 20%.[1] Although the Minister conceded that a 25% tax at the entry point discouraged many in coming to the tax net voluntarily, observers see the gesture as bait for the middle class electorate. As a measure to curb luxury consumption, the Minister increased the rate of expenditure tax[2] for certain hotels from 10% to 20%.

In view of the employment potential of poultry farming and to encourage investment in this activity, the Minister announced that 33⅓% of income derived from poultry farming will be exempt from tax. Similarly, payment of tax on professions has been allowed as a deduction in computing income under the head "salaries".[3]

Tax deduction at source is always a disincentive. Presently, there is no tax deduction at source for dividend payments up to 2,500 Rs. This provision has been extended to interest payments on bonds and debentures. As a measure of relief and also to help the newly-established National Housing Bank (NHB), the deposits made in the Home Loan Account Scheme of the NHB as well as the repayment of housing loans received from the bank have become deductible under Sec. 80C of the Income Tax Act. Furthermore, the taxpayers will not get a tax concession under Sec. 54E on capital gains if the sale proceeds are invested in bonds and debentures issued by the NHB.

To stimulate the flow of personal savings into equity, the Minister announced the introduction of an equity-linked saving scheme (details to be announced shortly). Investments under this scheme will be eligible for tax deductions on the basis of net annual additions to such savings. It is hoped that the scheme will boost the capital market as large numbers of middle class investors who have hitherto depended on fixed securities will be encouraged to opt for equity shares to avail themselves of tax concessions.

INDIRECT TAXES

The thrust of indirect tax proposals was to raise additional resources from relatively affluent sectors of the population. Accordingly, items like iron and steel, electronics, motor vehicles and cigarettes were specially picked up for additional excises. First, the Minister increased the existing specific duty rates of a large number of commodities by 5% of current rates with suitable rounding off. To avoid increasing the burden on the vast majority of the population, items of mass consumption were kept outside the purview of this upward adjustment. These items include sugar, tea, coffee, petroleum products (e.g. kerosene, diesel and motor spirits), vegetable oils, cotton yarn and fabrics, electric bulbs and fluorescent tubes. Experts fear that the 5% across-the-board hike in excise duty will adversely affect the price situation particularly when it is considered in relation to the 11% hike in freight rates announced in the railway budget.

The Minister picked up a few commodities for a higher rate of adjustment than the general 5% increase. Thus, the duty on pig iron was increased from 80 Rs. to 200 Rs. per tonne; on certain steel items from 365 Rs. per tonne to 500 Rs. per tonne; on certain hot rolled flat products such as sheets, strips, etc. from 500 Rs. to 700 Rs. per tonne; and on certain cold rolled flat products such as sheets and strips from 715 Rs. to 900 Rs. per tonne.

Frequent upward revision of excise duty on cigarettes

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1. The Finance Ministry officials clarified that the 8% employment surcharge would affect only 10% of the total of 7 million taxpayers. At the same time, 90% of the taxpayers would be paying less tax as a result of the reduction of the tax rate at the entry point.
2. The Expenditure Tax Act, 1987 provides for the levy of a tax on expenditure incurred in hotels where the room charges for any unit of residential accommodation are 400 Rs. or more per day per individual. The tax is levied on the expenditure incurred in connection with provision of any accommodation, food, drinks and certain other categories of services. It does not apply to expenditure incurred in foreign exchange or in the case of persons enjoying diplomatic privileges.
3. The tax on professions is levied by the State Governments under Art. 276 of the Constitution which also imposes a monetary limit of 250 Rs. per annum on this tax. However, under the Constitution Amendment Act, 1988, the ceiling of tax on professions has been raised from 250 Rs. to 2,500 Rs. per annum with the objective of enabling the States to raise additional resources.

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is a notable feature of exise tariff in India. No surprise that the commodity has earned such nicknames as *annual hardy, old faithful,* etc. The philosophy underlying hikes in duty on cigarettes has been to collect additional revenues at minimum resistence. Successive Finance Ministers have often sermonized in their Budget Speeches while enhancing the duty on cigarettes. In the present Budget the Minister observed: "Smokers who do not pay any heed to the statutory warning to their health should, I feel, at least contribute more to the health of the national economy". Thus, he raised the duty rates on cigarettes in general but the extent of increase would be more in the case of filter cigarettes of length above 70 mm. Non-filter cigarettes of length up to 60 mm will carry a rate of excise duty of 1 Re. per packet of 10. Lest the drinkers should feel let down, the excise duty on molasses, the principal raw material for the manufacture of liquor, was increased from 60 Rs. per tonne to 120 Rs. per tonne.

In a significant move, the Minister withdrew the concessional rate of excise duty on fuel efficient automobiles. Hitherto the rate of duty on fuel efficient automobiles of engine capacity not exceeding 1000 c.c. was 25%, and in respect of such automobiles of engine capacity exceeding 1000 c.c. it was 30% against the rate of 35% for other automobiles. Now a uniform rate of 35% will apply to all motor cars, vans and jeeps. The structure of the excise duty on colour television sets has also been rationalized. The new rates of duty are: 2,250 Rs.per colour television set without remote control, 2,500 Rs. per set with remote control, and 4,000 Rs. per set having the facility of "picture in picture".

The rate of foreign travel tax has increased from 50 Rs. per ticket for travel to neighbouring countries to 150 Rs.and in respect of travel to other countries from 100 Rs. per ticket to 300 Rs. More importantly, the Minister announced the levy of a new tax called inland air travel tax at the rate of 10% of the basic fare. However, passengers paying air fare in foreign currency are exempt from the new levy.

In view of the importance of the capital goods industry for achieving self-reliance and modernization of the economy, the Finance Minister announced substantial concessions in respect of customs duties on imports of capital goods. The Minister extended the duty concession for the import of machinery under the technology upgradation scheme for the capital goods industry to 4 more sectors, i.e. cutting tools, commercial tool rooms, textile machinery and paper machinery. He also announced a cut in import duty on general projects and machinery from 90% to 80% ad valorem. The import duty on paraxylene was reduced from 120% to 90%.

BUDGET 1989-90 AT A GLANCE

(Rs. billion)

	1987-88 Actuals	1988-89 Budget estimates	1988-89 Revised estimates	1989-90 Budget estimates
Revenue receipts	372.3	428.0	431.4	526.3
Capital receipts	220.3	232.8	247.1	221.9
Total receipts	*592.5*	*660.8*	*678.4*	*748.2*
Revenue expenditure	463.6	526.4	541.7	596.4
Capital expenditure	187.1	209.2	216.2	225.2
Total expenditure	*650.7*	*735.6*	*757.8*	*821.6*
Overall deficits	*58.2*	*74.8*	*79.4*	*73.4*

Source: Government of India, *Budget Papers,* 1989-90

The net additional revenue from direct taxes would be 5,300 million Rs. The indirect tax proposals would yield a net additional revenue of 7,570 million Rs. Out of the total net additional revenue of 12,870 million Rs., the States' share is 3,840 million Rs., the Centre being left with 9,030 million Rs. Thus, the anticipated deficit of 82,400 million Rs.in the Union Budget stands reduced to 73,370 million Rs. The current financial year 1988/89 closes with an overall deficit of 79,400 million Rs.

Industrial circles reacted adversely to the Budget proposals. Dalal Street in Bombay, the largest stock exchange in the country, reported a fall in its "sensitive index" relating to nearly 30 scrips from 663 to 636 soon after the Budget. This was the result of disappointment among investors who had expected abolition or at least some reduction in the tax on dividends received by shareholders from the company's taxed profits. However, the fall in share prices was arrested and partially reversed when public sector financial institutions provided the buying-support.

While the Government has termed the Budget anti-poverty and employment-oriented, the opposition parties have called it an exercise in political symbolism and election rhetoric by means of a sugar-coated pill.

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SINGAPORE:

1989 Budget: Pro-Business or Pro-Family?

Lee Fook Hong, MBA, FCIS, FAIA

I. INTRODUCTION

On 3 March 1989, the Minister for Finance, Dr. Richard Hu, presented Singapore's Budget for fiscal year 1989/90 to Parliament. As usual, the Minister presented his Budget Statement in 3 sections.

In the review of economy in Sec. 1, the Minister dealt with the 1988 economic performance. The issues covered include long-term Provident Fund Rate Adjustment, Skills Development Fund, Foreign Workers' Levy and the outlook for 1989. The estimated growth for 1989 is between 6% and 7%.

In Sec. 2, the Minister outlined 3 basic objectives on the basis of which the 1989 Budget was formulated:

(1) the need to maintain an overall balanced Budget over the long term;
(2) to continue investing for the future; and
(3) to foster growth of the private sector.

In Sec. 3, the Minister projected the tax revenue for the fiscal year 1989 and announced various changes to taxation.

II. TAX CHANGES

A. Company taxation

1. Corporate income tax

The corporate tax rate will be reduced from 33% to 32% from year of assessment 1990. This is a modest reduction but it does indicate the direction in which corporate taxation will move if economic conditions permit. Singapore's corporate tax structure remains one of the most competitive in the world.[1]

2. Withholding tax exemption on swap transactions

To enable banks in Singapore to be competitive in providing financial packages to their international customers, an exemption from withholding tax will be granted for swap transactions. The exemption will take effect from 1 April 1989. The exemption from withholding tax will apply only to transactions between Asian Currency Units (ACUs) and non-residents, and transactions which do not involve the Singapore dollar. With the exemption, banks in Singapore will be able to offer their clients swap arrangement facilities at more competitive rates. The withholding tax exemption is part of the Government's effort to further develop Singapore as an international capital market.

3. Extension of one year accelerated depreciation to other automation equipment

Since 1985, the one year accelerated depreciation allowance has been granted for the purchase of robots and other types of automated equipment. Thus far this allowance has only been extended to robots, computer-aided design systems (CAD) and computer-aided manufacturing systems (CAM). With effect from year of assessment 1990, the accelerated depreciation allowance of 100% in one year will be extended to include automated machine equipment, automated guided vehicles, automatic testing/inspection equipment, and automatic retrieval and insertion devices.

4. Tax deduction for computer equipment donations to approved educational and research institutions

A tax deduction will be allowed for donations of computer equipment by companies to approved educational and research institutions. This scheme will be administered by the Ministry of Finance and it will be effective from year of assessment 1990. The objective of the scheme is to help upgrade and maintain the quality of training in Information Technology.

5. Tax incentive for building modifications for the disabled

Employers who modify their working environment to accommodate disabled workers will be granted a once-off deduction against income for expenditure incurred

1. Below is a comparison of corporate tax rates:

Singapore	32%
Australia	39%
Hong Kong	16.5%
Japan	42%
Malaysia	35%
South Korea	30%
Taiwan	25%
Thailand	35%
United Kingdom	35%
U.S.A.	34%

As a corollary to the reduction, dividends paid on or after 1 January 1989 would carry a credit of 32%.

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in effecting modifications. The maximum amount of the deduction allowable is S$ 100,000 and this incentive is effective in respect of modifications undertaken from 1 January 1989.

B. Personal taxation

1. Individual income tax

Income tax rates for individuals will remain unchanged.

2. Increase in personal reliefs

(a) *Handicapped dependant relief*
From year of assessment 1990, relief for handicapped dependants will be raised from S$ 750 to S$ 2,500. The relief is available for each handicapped dependant who is *either* a sibling of the taxpayer or his spouse living in the same household, *or* an unmarried child; and who is unable to maintain himself by reason of physical or mental infirmity. The relief will be allowed so long as the handicapped dependant does not have an income of more than S$ 1,500 in the year (currently $ 750).

(b) *Aged dependant relief*
Aged parent relief will be increased from S$ 1,000 to S$ 2,500 with effect from year of assessment 1990. This relief is available to an individual resident in Singapore who maintains in the same household his own or his spouse's parents, grandparents or great-grandparents, who are 55 years or over or otherwise incapacitated. The dependant's annual income must not exceed S$1,500 and relief for the same dependant must not have been claimed by any other person. A taxpayer can claim relief for up to 2 such dependants.

(c) *Wife relief*
The relief for wife will be increased from S$ 1,000 to S$ 1,500 with effect from year of assessment 1990.

(d) *Normal child relief*
Normal child relief for the first, second and third child will be increased from S$ 750 to S$ 1,500 each with effect from year of assessment 1990.

(e) *Enhanced child relief*
With effect from year of assessment 1990, Enhanced Child Relief for the second, third and fourth child below 12 years of age will be increased from the present 10, 15 and 15% of the mother's earned income to 15, 20 and 25%, respectively. The maximum claim for the Enhanced Child Relief for the second, third and fourth child below 12 years old shall also be increased from S$ 10,000 to S$ 15,000.

The aim of the above increased reliefs is to alleviate the financial burden of families with children, aged or handicapped dependants.

3. Procreation incentives: special tax rebate

A Special Tax Rebate of S$ 20,000 for a third child born on or after 1 January 1987 was announced in the 1987 Budget. To further encourage new births, a similar Special Tax Rebate of S$ 20,000 will be granted for a fourth child born on or after 1 January 1988. Therefore, a tax-free period of up to 5 years can be claimed by either the husband or wife, subject to a maximum rebate of S$ 20,000 against their total tax liabilities over the period. This rebate will be available from year of assessment 1989.

An additional tax rebate equivalent to 15% of the wife's earned income, to be offset against the wife's tax liabilities only, will also be granted for the birth of the fourth child in lieu of maternity leave.

The above special tax rebates are given only once and must be absorbed within a period of 5 years. Normal child relief of S$ 1,500 will also be granted to the fourth child born on or after 1 January 1988. Enhanced child relief and special tax rebates for the third child are granted only in respect of a legitimate child or stepchild but not to an adopted child.

4. Tax deduction for contributions to Central Provident Fund (CPF) and other approved pension and provident funds

Currently, all compulsory contributions by individuals to the CPF and other approved pension and provident funds are fully tax deductible. To prevent the use of these funds as tax shelters, the following changes will be introduced with effect from year of assessment 1990:

(a) The tax deduction for an individual's contribution to approved funds, including the CPF, will be limited to the statutory contributions under the CPF Act. The statutory contribution is currently 24% of the ordinary wages subject to a ceiling of S$ 1,440 per month.

(b) For additional wages such as commissions and bonuses the statutory contribution is currently 24% of the additional wages with no fixed ceiling. The maximum limit for contributions in respect of ordinary wages can be circumvented by converting ordinary wages into bonuses.

From year of assessment 1990, the tax deduction in respect of contributions relating to additional wages will be restricted to the statutory CPF contribution from additional wages not exceeding 40% of the annual ordinary wages.

(c) From year of assessment 1990, an employee will be liable to tax on the excess:
- where an employer's contributions to the approved funds and CPF are in excess of the statutory requirements under the CPF Act; or
- where an employer's contributions are based on additional wages in excess of 40% of the employee's annual ordinary wages.

C. Property tax

The following 3 major property tax concessions were also announced:

(1) exemption from property tax for lands under private development;

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(2) the property tax assessment on hotels at 15% of gross receipts for rooms and 5% for food and beverage outlets; and
(3) the payment scheme of property tax by monthly instalments through GIRO.

The 50% rebate on property tax which is due to expire on 30 June 1989 will be extended for another year until 30 June 1990.

From 1 July 1990, the property tax rate of 23% will be reduced to 16% of annual value. The Government will continue to closely monitor the property tax system to ensure that it remains competitive.

Also from 1 July 1990, property tax on all non-Housing Development Board (HDB) owner-occupied residential properties will be standardized at a flat rate of 4% of annual value. Presently, the property tax of owner-occupied residential properties is assessed on a concessionary basis at the discretion of the Property Tax Department.

A new system of assessing HDB residential properties will also be implemented. Details of the implementation of the new system will be announced in due course.

D. Other tax changes

1. Stamp duty for property transactions

Currently all property transactions except stock and marketable securities are chargeable to stamp duty at the following rates:
2% for the first S$ 30,000
2.5% for the next S$ 20,000
3% for the amounts exceeding S$ 50,000

To reduce the cost of buying and selling HDB properties and to facilitate upgrading and relocation, the stamp duty on property transactions except stocks and marketable securities will be reduced to:
1% for all properties up to S$ 90,000
2% for the next S$ 60,000
3% for all incremental values above S$ 150,0000

The revised structure will be effective from 1 April 1989.

2. Duty on tobacco and cigarettes

As part of the continuing national effort to discourage smoking in Singapore, import and excise duties on cigarettes and tobacco will be increased with effect from 3 March 1989. This is the third consecutive year in which such duties have been increased. The increases are as follows:

Import duty on cigarettes	From S$ 75 to S$ 85 per kg
Import duty on tobacco	From S$ 36 to S$ 42 per kg
Excise duty on cigarettes	From S$ 36 to S$ 40 per kg

3. Taxes on public utilities and telephone services

(a) *PUB charges*
The 10% tax on utilities and gas consumption was suspended from 1 November 1985 to 31 March 1989. The 10% tax on water charges in excess of S$ 20 per month, however, continued.

To replace these 2 taxes, a 5% tax will be imposed on the combined PUB (Public Utilities Board) charges for water, gas and electricity consumed by domestic users in excess of S$ 40 per month. The 5% tax will be effective from 1 April 1989.

(b) *Telephone charges*
The suspension of the current 20% tax on domestic telephone services and trunk call services to West Malaysia expired on 31 March 1989. From 1 April 1989, a 5% tax on these services is imposed for residential subscribers. However, the suspension remains in effect for business subscribers.

III. CONCLUSION

In conclusion, the Minister emphasized that the Singapore Government would continue with its policy of collecting adequate revenue to cover expenditure.

While most businessmen in Hong Kong regard the recent Budget as a pro-business Budget, most Singaporeans view Singapore's 1989/90 Budget as a pro-family Budget.

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SOUTH AFRICA:

The 1989 Budget Policy

Dr. Erwin Spiro

The 1989 Budget was presented by Mr. Barend du Plessis, the Minister of Finance, on 15 March. He emphasized that the Budget was not an election budget. On the contrary, the tax burden was to rise for the personal sector in consequence of the increase in sales tax and the fact that no concessions were made for fiscal drag. What the Budget seeks to ensure, in difficult circumstances, is that the South African economy moves forward on all fronts on a sound basis.

I. INCOME TAX

Primary rebates

The primary rebate is to be increased from R 1,100 to R 1,250 for married taxpayers and from R 750 to R 850 for other taxpayers. To provide taxpayers over 65 with further assistance, their present additional rebate is to be increased – in addition to the above mentioned general rebate – from R 500 to R 1,450.

It follows that the tax threshold will rise for an unmarried person from R 5,357 to R 6,071; for a married person with 3 children from R 10,000 to R 11,071; and for a married person older than 65 from R 11,428 to R 17,304.

Provisional tax

Individuals over 65 are not required to submit provisional tax returns if their taxable income consists only of salary, pension and investment income and does not exceed R 20,000. This exemption limit is to be increased to R 25,000.

Standard income tax on employees (SITE)

Under the standard income tax on employees, the tax liability in respect of remuneration up to R 12,000 per year for a man or unmarried woman, or R 20,000 in the case of a married woman, is finally determined at the end of a tax period and no income tax returns need to be submitted.[1] In order to provide further relief and to tax working wives separately, SITE is now to be applied to all married women receiving remuneration.

Mining taxation

A new comprehensive tax formula is to be introduced in which the existing formula tax and the surcharge of 25% are first consolidated and then slightly reduced.

For non-gold mines, the surcharge of 15% above and beyond the normal tax will be reduced to 12%.

As regards diamond mines, the statutory rate will be increased to the standard company rate of 50%, but the surcharge will be reduced from 25% to 12%, amounting to a small reduction in the effective tax rate.

Long-term insurers

From 1 April 1989, long-term insurers will be taxed according to a formula proposed by the Margo Commission calculating the tax by multiplying the tax rate by the expression (I or "insurers' income", as defined, less E or his "expenses", as defined). For the 1989/90 financial year, the tax rate will be equal to 45% (i.e. the maximum marginal rate for individuals). Long-term insurers will, at this stage, be allowed to deduct from their income only 55% of their expenses for purposes of calculating their taxable income.

II. RATES OF NORMAL TAX

Persons other than companies

Taxable income derived from sources within or deemed to be within the Republic (excluding taxable income derived by any person from the carrying on of a long-term insurance business) for the year of assessment ending on 28 February 1990 or 30 June 1990, whichever is applicable, is subject to (normal) income tax calculated in accordance with Tables I and II hereunder. In the case of the carrying on of a long-term insurance business, whether by a company or by a person other than a company, the tax is 45 cents on each rand of such taxable income.

Companies

Taxable income derived from sources within or deemed to be within the Republic for every year of assessment ending during the period of 12 months ending on 31 March 1990 is subject to the following rates of (normal) income tax;

(1) on each rand of the taxable income of any company (excluding taxable income derived from mining operations and taxable income derived from certain excess recoupments and taxable income de-

1. See 42 *Bulletin for International Fiscal Documentation* 6 (1989) at 259.

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rived by any person from the carrying on of long-term insurance), 50 cents;
(2) the taxable income derived from mining operations – see above (there still being a distinction between a post-1966 gold mine and any mine other than a post-1966 gold mine);
(3) in the case of the excess recoupments mentioned in (1) above, the tax is the average as determined in accordance with the Act or 35 cents per rand, whichever is higher.

Rates of other taxes contained in the Income Tax Act

The non-resident shareholders tax is 15% of the amount of dividends or interim dividends. The undistributed profits tax is 33⅓ cents on every rand by which the distributed income as defined exceeds the amount of dividends distributed during the specified period, as defined. Donations tax is payable at a flat rate of 15% on the value of the donations subject to the tax.

Table I

Taxable income	Rates of tax in respect of married persons
Where the taxable income–	
does not exceed R 12,000	14% of each R 1 of the taxable income;
exceeds R 12,000 but does not exceed R 13,000	R 1,680 plus 15% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 1,830 plus 17% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,000 plus 19% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,190 plus 21% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,400 plus 23% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 2,860 plus 25% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,360 plus 27% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 3,900 plus 29% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 4,480 plus 31% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,100 plus 33% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 5,760 plus 35% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 35,000	R 6,460 plus 37% of the amount by which the taxable income exceeds R 30,000;
exceeds R 35,000 but does not exceed R 40,000	R 8,310 plus 39% of the amount by which the taxable income exceeds R 35,000;
exceeds R 40,000 but does not exceed R 50,000	R 10,260 plus 41% of the amount by which the taxable income exceeds R 40,000;
exceeds R 50,000 but does not exceed R 60,000	R 14,360 plus 42% of the amount by which the taxable income exceeds R 50,000;
exceeds R 60,000 but does not exceed R 70,000	R 18,560 plus 43% of the amount by which the taxable income exceeds R 60,000;
exceeds R 70,000 but does not exceed R 80,000	R 22,860 plus 44% of the amount by which the taxable income exceeds R 70,000;
exceeds R 80,000	R 27,260 plus 45% of the amount by which the taxable income exceeds R 80,000.

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Table II

Taxable income	Rates of tax in respect of persons who are not married persons
Where the taxable income–	
does not exceed R 10,000	14% of each R 1 of the taxable income;
exceeds R 10,000 but does not exceed R 11,000	R 1,400 plus 15% of the amount by which the taxable income exceeds R 10,000;
exceeds R 11,000 but does not exceed R 12,000	R 1,550 plus 17% of the amount by which the taxable income exceeds R 11,000;
exceeds R 12,000 but does not exceed R 13,000	R 1,720 plus 19% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 1,910 plus 21% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,120 plus 23% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,350 plus 25% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,600 plus 27% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,140 plus 29% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,720 plus 31% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,340 plus 33% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,000 plus 35% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,700 plus 37% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 6,440 plus 39% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 36,000	R 7,220 plus 41% of the amount by which the taxable income exceeds R 30,000;
exceeds R 36,000 but does not exceed R 42,000	R 9,680 plus 42% of the amount by which the taxable income exceeds R 36,000;
exceeds R 42,000 but does not exceed R 48,000	R 12,200 plus 43% of the amount by which the taxable income exceeds R 42,000;
exceeds R 48,000 but does not exceed R 54,000	R 14,780 plus 44% of the amount by which the taxable income exceeds R 48,000;
exceeds R 54,000	R 17,420 plus 45% of the amount by which the taxable income exceeds R 54,000.

ERRATUM

In the article "The Tax Structure of Botswana" by John F. Due, published in the January 1989 issue of the *Bulletin*, the following corrections should be noted:

Page 11, the last word on the page should read 15%, not 18%.

Table 5, the rate on Traditional beer is 3, not 1.6.

Any inconvenience is regretted.

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SRI LANKA:

Budget Proposals: 1989

Ernst & Whinney, Colombo, Sri Lanka

The 1989 Budget Speech was presented on 16 March by the Minister of Finance, Mr. D.B. Wijetunge. This article highlights the salient features of the proposals – the surcharge on income and wealth tax, the new stamp duty on certificates of deposit, the withdrawal of the 12,000 Rs. exemption for dividend income, 100% tax deduction for contributions to the Janasaviya Programme, withholding tax on Government securities and Treasury bills and an additional turnover tax to be collected and remitted by manufacturers and importers on behalf of their dealers/customers.

PERSONAL TAXATION

No changes were made to the tax-free allowance of 27,000 Rs. for resident individuals. The personal income tax rates too remain unchanged as do the wealth and capital gains tax.

A 15% surcharge on all income tax and wealth tax, however, will be payable for the 1989/90 and 1990/91 years of assessment. The payments will be made in 2 equal instalments in August and November of each year.

Dividend exemption

It is proposed to withdraw the 12,000 Rs. exemption for dividend income, effective from the year of assessment 1989/90.

Certificates of deposit (CDs)

Currently, interest earned on CDs is not exempt from income tax under the provisions of the Inland Revenue Act. Due to the anonymity of the deposit holder, however, such income can be taxed only if declared or detected by the authorities. No withholding tax can be imposed on interest from CDs for the same reason. It has been proposed to levy a stamp duty of 3% on the face value of all CDs issued by Commercial Banks, Finance Houses or the Treasury. For example, a CD of 100,000 Rs., carrying interest of 15% per annum, would be liable to a stamp duty of 3,000 Rs., i.e. 20% of the interest earned. The stamp duty is effective immediately with respect to all CDs (even those already issued) and is payable at maturity for existing deposits and at the time of deposit in the case of new deposits.

Treasury bills and Government securities

At present, interest on Government securities is not subject to the 20% withholding tax which applies to interest payable on deposits with banks and financial institutions. It has been proposed to extend the withholding tax to interest payable on Government securities.

No withholding tax is currently levied on interest derived from Treasury bills. It is proposed to impose a non-refundable 9% withholding tax on the face value of Treasury bills held by the Central Bank and a 2½% per annum withholding tax on the face value of Treasury bills held outside the Central Bank. This too is payable at maturity in the case of existing bills and at the time of deposit in the case of new bills.

Donations – Janasaviya Programme

The thrust of the country's development programme over the next 2 years is to alleviate poverty and create village-based self-reliant organizations and small production units. These facilities would help to improve the productivity of the poor through the creation of new employment opportunities, bring additional income to the inhabitants of the villages and provide a sound indigenous base to industry. In an effort to promote this programme, all donations to the Janasaviya Fund[1] are to be tax-deductible without limit.

New industrial and agricultural undertakings which create employment under the Janasaviya Programme for at least 10 persons in specified areas of high unemployment (or those covered by food stamps/ Janasaviya Programme) will be entitled to a double deduction of Employee Provident Fund and Employee Trust Fund contributions made by the employer for tax purposes.

Amnesty

An amnesty has been offered to taxpayers who have undeclared earnings provided that such monies are invested in the National Savings Bank between 1 April 1989 and 30 June 1989. A tax of 20% will be levied on such deposits. The balance monies should be invested

1. The Fund will accept donations to be used in a particular village or hamlet.

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within 2 years in an agricultural or industrial undertaking with employment opportunities for at least 10 persons under the Janasaviya Programme.

COMPANY TAXATION

No changes to the company tax rates, capital gains tax or capital allowance are proposed. As with the personal income tax, however, a 15% surcharge has been imposed on income tax which will be payable for the years of assessment 1989/90 and 1990/91. The surcharge is not likely to be imposed on the dividend tax or tax on overseas remittances by non-resident companies.

TURNOVER TAX

Manufacturers and importers currently pay the turnover tax at the rates applicable to them and retailers pay turnover tax generally at the rate of 1%. Because a large number of retailers either do not pay the turnover tax or the correct turnover tax, it is proposed to recover from all manufacturers and importers a further 1% turnover tax on all their sales. This tax would be payable in addition to the tax currently imposed.

Any dealer who purchases goods from a manufacturer or importer will be entitled to take credit for this tax against the turnover tax payable on the sales. For this purpose, the purchases should be supported by sales documents issued by a registered manufacturer or importer.[2] This proposal will require an amendment to the Turnover Tax Act and is therefore likely to take effect when the new legislation is passed.

The existing 20% turnover tax on the following luxury goods will be increased to 40%, effective at midnight 16 March 1989: cosmetics, hair and toilet articles (other than soap, tooth powder and toothpaste), perfume, eau-de-cologne, chandeliers, woollen carpets and rugs.

PROVIDENT FUNDS AND EMPLOYEE TRUST FUNDS

Currently, the income tax rates applicable to the investment income of provident funds, pension funds and charitable institutions is 20%. The rate of tax on provident funds has been reduced to 10%, effective 1989/90 year of assessment. Various representations have been made for the total removal of the 20% tax on the income of provident funds. The reduction in the rate will therefore afford some measure of relief to employees contributing to approved provident funds. It is likely that the reduced rate will also apply to pension funds although these funds were not specifically alluded to in the Budget Speech.

Income from Government securities and Treasury bills

Interest from Government securities and Treasury bills is exempt from income tax in the hands of the provident and pension funds. This exemption has been withdrawn in respect of provident funds, and it is likely that it will also be withdrawn in respect of pension funds although no statement was made to this effect. The withdrawal is effective from the 1989/90 year of assessment.

Taxation of employee's provident fund and employee's trust fund

The exemption for income from these funds has been withdrawn, effective 1989/90 year of assessment. As a result, all provident funds will be treated equally for tax purposes, i.e. the rate applicable for both funds is 10%.

MISCELLANEOUS

Non-national shareholdings

It is proposed to abolish the 100% transfer tax applicable to the transfer of shares to non-nationals. The 100% transfer tax applicable to the transfer of land to non-nationals would remain in effect.

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2. On the basis of this proposal, if a sale is made by a manufacturer or importer to a wholesaler, the wholesaler will be entitled to take a credit for the extra 1% turnover tax recovered on the turnover tax. The wholesaler is not required, in turn, to recover an extra 1% when a sale is made to a retailer. Where the manufacturer or importer sells directly to the consumer, the extra 1% will probably have to be recovered unless a specific exception is provided for in such a case. It is likely that the amending legislation will require the manufacturer or importer to state the additional 1% separately in the sales documents.

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SWAZILAND:

Extracts from Budget Speech 1989

presented by the honourable B. Sibusiso Dlamini M.P. Minister for Finance to the Parliament of the Kingdom of Swaziland on 20 February 1989

TAX REFORM

24. Mr. Speaker, one of the key policy instruments available to Government is the tax structure. As I have indicated, appropriate policy involves the use of the tax structure to promote structurally sound development within the economy, and I therefore wish to maintain the momentum of the previous two years by proposing a number of further amendments to the tax structure. Before adding the detail I would like to briefly restate Government's position with regard to fiscal incentives, by noting that the primary role of tax incentives is that of easing the cost of relocation to, and set-up in, Swaziland. Unlike some competing locations, the economic environment in the country is generally attractive, and it is therefore regarded as unnecessary to provide subsidies to ongoing activities. Much of the fiscal incentive structure – especially the Tax Holiday scheme – has been constructed upon this premise. In addition however the tax system can be used to address some of the perceived weaknesses in the economy – such as for example training, and export promotion in the small scale sector.

25. In respect of the latter, I therefore propose that, in view of the costs incurred by the small scale handicraft and cottage industry sector in achieving export market penetration, approved export promotion expenditure will be granted an enhanced set-off against tax. It is hoped that this incentive will encourage greater export development in this sector and thereby act as a stimulus to income and employment. I must stress though that this scheme will be tightly controlled, and that the tax relief will only be obtainable when genuine export growth has been achieved. A number of isolated cases in Swaziland has shown that this sector can survive in the export sector, and I believe that the stimulus offered here will be of benefit to the economy and to revenue.

26. Mr. Speaker, I am pleased to report that the tax cuts I announced in the 1988 Budget were successfully implemented. This year I wish to continue in the same direction by making a number of structural adjustments to the personal tax structure, adjustment which will significantly change the tax code in the country. I therefore propose the following amendments:

(i) the ceilings for allowable deductions against taxable income are to be inflation adjusted;
(ii) the average rate of tax will be reduced at every level of income, with the top marginal rate of tax being reduced from 45% to 40%;
(iii) the distinction between the rates of tax for married, unmarried and wives employment income is to be abolished, and replaced by a uniform rate of taxation for all taxpayers;
(iv) in compensation the primary rebate for single taxpayers will be abolished.

27. The impact of these changes will be significant, from the point of view of both the taxpayer and the Government. As a result of the amendments all taxpayers will now face a lower real burden of tax. The reduction will be greatest for people currently on the single and married women's scales, although it will also be significant for married taxpayers.

28. From the point of view of the Department of Taxes, the revisions will greatly simplify the personal tax structure and it is hoped this will improve the efficiency of collection. From a purely economic point of view, the amendments help to eliminate one of the main areas of unjustified discrimination in the tax system. In very many cases the cost burden of families is shared across all members, and in this respect it seems inappropriate to tax according to a false theory of cost sharing in families which involves unequal tax treatment of husbands and wives. This new single rate taxation system redresses this discrimination through the creation of horizontal equity in tax before rebates, with the rebates themselves offsetting any cost inequalities that arise from different family composition. I may also finally add that this move is consistent with the aims of tax legislators around the world, and in particular amongst a number of African countries.

29. In addition I propose to revise Section 59 of the Order to improve collection of withholding tax on non-resident contractors and other non-resident companies, and in addition propose to raise the rate of tax on such companies from 5% to 10%.

30. There are two further areas of taxation which I feel warrant examination, the first being that of tax relief on mortgage interest payments, and the second the possibility of direct user charges for public services. In terms of the former, I believe that at present the housing market is distorted by the access some housebuyers have to concessional loan finance. Those people who do not have access to such schemes face significant difficulties in raising loan finance, and I therefore have instructed the Commissioner of Taxes, and the Tax Advisory Committee to undertake a full evaluation of the introduction of tax relief on mortgage interest payments for this section of the market. On the latter issue I believe that we must begin to examine the need for the users of some public services to contribute directly to the cost of the service. Although this is not appropriate for all public services, it is appropriate for those services such as the road system which are consumed as private goods, and are used extensively by non-taxpayers. The Road Levy Bill which comes under the portfolio of my colleague, the Minister for Natural Resources and Energy, is an example

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of one such direct user charge. The Road Levy Fund, which has received strong support from the African Development Bank, will be a dedicated fund to be used solely for road maintenance. I believe that this development needs to be supported, and that the wider application of similar such schemes be considered.

31. Mr. Speaker, whilst on the subject of taxation I wish to submit for the approval of this House, in accordance with Section 9 of the Sales Tax Act 1983, the following amendments to the Schedules to the Act. The purpose of these amendments, which will come into force by Legal Notice in the Government Gazette published today, is to improve the efficiency of the Act, to close some loopholes in the Schedule, and to maintain consistency with the Customs Schedules which are amended from time to time in accordance with the SACU Agreement. I therefore propose that:

(i) The exemption from Sales Tax currently covering Government departments will be removed;
(ii) The refund procedure for approved diplomats will be replaced by an exemption scheme;
(iii) Limits will be placed on the value of items imported tax-free under the personal import provision;
(iv) Advertising services, other than those provided by the Swaziland Television and Broadcasting Corporation (STBC) and Swaziland Broadcasting Service (SBS) will be taxable;
(v) Small manufacturing companies will now be liable to tax on their turnover, rather than on their number of employees;
(vi) Tax exemptions will be removed from unmarked packaging materials, structural steelwork and most roofing materials, and extended to plain steel bars, audiometric and ophthalmic equipment;
(vii) The threshold for tax exemption on services will be abolished.

TRINIDAD AND TOBAGO:

Tax Reform Proposals

John Rodway

Mr. Rodway is acting TNS correspondent for the Caribbean.

Major tax reform proposals effective from 1989 were announced when the January 1989 Budget was presented to Parliament. According to the Trinidad High Commission in London, several of the proposals have already been enacted into law.

The stated object of the reform is to "develop a tax regime that is fair, efficient and relatively simple to administer". The opportunity has also been taken to reduce personal income taxes by drastically cutting the number of deductions allowed, and to simplify and reduce corporate tax rates.

SOME DETAILS OF THE REFORM

Personal income tax

New rate scale:

Chargeable income (TT$)	Rate (%)
Slice 1 – 12,000	5
Slice 12,001 – 20,000	20
Slice 20,001 – 40,000	40
over 40,000	45

The old scale had 11 rate brackets ranging from 5% to 50%. There was also a 5% surcharge (surtax) on higher income; this is abolished.

New system of personal reliefs

Personal reliefs, drastically reduced in number to 3, will be given by way of non-refundable tax credits, TT$ 600 for the taxpayer, TT$ 600 for a spouse with income not exceeding TT$ 3,000, and TT$ 100 for each child for whom an allowance could be deducted from income under the old system. All other personal reliefs including those for life insurance premiums and the health surcharge go.

Tax rebates for small incomes disappear.

Under the new system of rates and tax credits a married man with 2 dependent children will have no income tax liability unless total income exceeds TT$ 16,000 (example).

Reliefs for personal expenditures

The deductions for net increases in investments in co-operative society and credit union shareholdings and in units in the Unit Trust Corporation are abolished, but replaced by less favourable tax credits of 20% of the net increases up to a maximum of TT$ 1,500. The maximum credit for each is therefore TT$ 300.

The deductions for investments in Tax-free Bonds and Housing Bonds are abolished.

The deduction for payments under non-charitable deeds of covenant made before 24 January 1987 is abolished.

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As regards charitable deeds of covenant payments, deduction is continued, but only up to a reduced limit of 15% of total income in any year of income.

Owner-occupied residential property

The annual rateable value (ARV) of owner-occupied residential property will no longer be included in income charged to tax. As a corollary, expenses incurred in respect of such property (e.g. fire insurance, repairs, maintenance, rates and property taxes) will no longer be deductible in calculating a taxpayer's chargeable income. However, interest on moneys borrowed to purchase, construct or improve an owner-occupied property, up to a maximum of TT$ 24,000 a year, in respect of not more than 2 properties, will still be deductible.

Employment expenses

From 1989, no deduction will be given for employment expenses except for unreimbursed travelling expenses incurred in the production of the employment income.

Interest income

Tax at 15%, instead of 10%, will be withheld by banks and other financial institutions from interest on all classes of savings or other accounts payable to residents. However, individuals will have the option to include such interest in their tax returns and if their marginal rate is 5%, claim repayment of excess tax withheld.

Severance payments, retirement severance benefits

At present these payments are exempted up to TT$ 80,000, the remainder being separately charged to tax at the recipient's average rate of the preceding year. From 1989 on, severance payments and retirement severance benefits will still be separately charged for the year of receipt, but the tax on them will be computed by dividing the payments by ⅓ applying the recipient's marginal rate to the result, then re-multiplying the tax on that result by 3. No part of the payments will be exempted from tax.

Employee savings plan withdrawals

Withdrawals will be aggregated with other income for taxation, and no longer taxed separately at the taxpayer's (top) marginal rate.

CORPORATE INCOME TAXES

Up to 1988, companies are liable to 4 taxes on income, namely the corporation tax, unemployment levy, national recovery impost and business levy, which do not necessarily have the same basis of assessment. Their combined rate is 49.5% at its maximum. From 1989 a single tax of 45%, corporation tax, will be charged on all companies except petroleum companies which are and will remain subject to a special tax regime.

Dividend income allowance

As a corollary of the corporate income tax rate reform, the "dividend income allowance" for individuals resident or ordinary resident in Trinidad is changed, so that from the income year 1989, they will in principle include 185% of Trinidad dividends received in taxable income, and receive a credit for the 85% gross up. This is almost a full imputation system in effect.

Under the tax reform, companies will no longer be entitled to an investment allowance for certain capital expenditures, or the employment allowance which gave a deduction of 150% of remuneration of new employees. The latter allowance is also abolished for non-company entrepreneurs.

OTHER TAXES AND CHARGES

Sales taxes

The Government was already committed to introducing a value added tax in 1990, but has nevertheless taken the opportunity to make some changes in taxes on goods and services, including excise duties and import duties. For example, the import duties on edible oil, margarine and imitation lards, and "edible fats" have been increased from 10% or 30%, to 45%; edible oil also suffers an increase in excise duty from 3 cents per litre to 15 cents per litre, at least if it is "deodorized".

Other charges

The (petroleum) exploration and production lease/licence fee is increased from TT$ 2,000 to TT$ 4,000, whilst the annual renewal fee for those leases and licences is increased from TT$ 300 to TT$ 500.

ADMINISTRATION

The Government is to introduce a statutory register of persons preparing income tax returns or transacting any other income tax business to be maintained by the Board of Inland Revenue. Individuals will have to pay an initial registration fee of TT$ 500, and partnerships or companies TT$ 1,000. An annual renewal fee of TT$ 100 will also be payable.

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UNITED STATES: INTERNATIONAL TAX ASPECTS OF FOREIGN CURRENCY TRANSACTIONS **312**

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UNITED STATES: MUTUAL ASSISTANCE ISSUES: LETTER TO THE IRS COMMISSIONER **321**

On 9 November 1988, an ad hoc committee of international tax practitioners sent a letter to the Commissioner of the Internal Revenue Service. The letter addressed the practitioners' concerns about various operational aspects of the U.S. Competent Authority programme. The text of the letter is reproduced in this issue.

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AUSTRALIA: NEW INTERNATIONAL TAX REGIME **327**

The proposals for wide-ranging changes to Australia's international tax regime will come into effect on 1 July 1990. The changes consist of the adoption of a controlled foreign company attribution system, a foreign passive investment fund attribution system, a new dividend exemption and foreign tax credit system and a new grantor trust attribution system, applicable to foreign trusts only. Will the new international tax system herald the end of international tax avoidance? This article offers an opinion.

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THE JERSEY EXEMPT COMPANY **334**

Effective 1 January 1989, the Jersey Corporation Tax Company is abolished and replaced by the concept of an exempt company. Under the new legislation, all companies incorporated in Jersey are resident in Jersey for income tax purposes and are liable to income tax on world-wide profits at 20% unless they elect for exempt company status. This article discusses the background of the Corporation Tax Company and examines the provisions of the amendment to Art. 123 of the Income Tax (Jersey) Law 1961.

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BULGARIA: FAVOURABLE CLIMATE FOR FOREIGN INVESTMENT **337**

The State Council's Decree 56 of 9 January 1989 introduced radical changes in the Bulgarian economic structure, the conditions for engaging in business activities and investment cooperation with foreign companies. This article briefly overviews the aspects of Decree 56 which deal with foreign investment and the business conditions for foreign persons and companies.

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Etats-Unis: Négocier avec les "sociétés de placement" des investissements étrangers (passive foreign investment companies: PFIC): comment minimiser le préjudice *303*

Les dispositions concernant les "sociétés de placement" des investissements étrangers ajoutées par la Loi sur la Réforme Fiscale de 1986, ont été récemment modifiées par la loi fiscale de 1988 consacrée aux problèmes techniques et divers. Cet article commente de façon perspicace les réglementations de base pour la détermination du statut de la PFIC, le traitement fiscal des actionnaires américains directs et indirects d'une PFIC, et se termine par quelques suggestions permettant d'éviter le statut de PFIC ou, si nécessaire, de vivre avec ce statut.

INHALTSVERZEICHNIS

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U.S.A.: Die Anwendung von „passiven" Auslandsinvestitionsgesellschaften (passive foreign investment company, PFIC): Wie man den Schmerz minimalisiert *303*

Die Bestimmungen für die „passive" Auslandsinvestitionsgesellschaften (PFIC), welche vom Steuerreformgesetz 1986 eingeführt worden sind, wurden vom „Technical and Miscellaneous Revenue Act 1988" abgeändert. Dieser Artikel gibt eine ausführliche Beschreibung der wichtigsten Bestimmungen, welche eine PFIC definieren, der Besteuerung von „direkten" und „indirekten" amerikanischen Aktionären einer PFIC und beschliesst mit einigen Anweisungen, um einen PFIC-Status zu vermeiden und, wenn es nicht anders möglich ist, sich mit dem PFIC-Status abzufinden.

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Robert Henrey:

Etats-Unis: Aspects fiscaux internationaux des transactions en devises étrangères 312
La loi américaine sur la réforme fiscale de 1986 introduit une nouvelle sous-section (sous-section J) dans l'IRC pour l'imposition des transactions des changes. Cette sous-section, ensemble avec les modifications introduites par le "TAMRA" et les réglementations s'y rapportant du "IRS" ont mis au point un ensemble complet de directives pour le traitement des gains et pertes en matière de changes. Cet article analyse de façon détaillée ces nouvelles règles. Bien que l'auteur constate une amélioration certaine de la situation par rapport à celle existant avant le TRA-86, il considère en conclusion que de nouvelles améliorations restent nécessaires.

Etats-Unis: Assistance mutuelle: Lettre au Directeur Général des Impôts 321
Une commission ad hoc a envoyé le 9 novembre 1988 une lettre au Directeur Général des Impôts. Cette lettre mentionne les inquiétudes des praticiens quant aux différentes applications du programme des Autorités Compétentes américaines. Le texte de la lettre est reproduit dans ce numéro.

Rick Krever:

Le nouveau régime fiscal international australien 327
Les propositions d'importantes modifications du régime fiscal international australien entreront en vigueur le 1er juillet 1990. Ces modifications comprennent l'introduction de dispositions par lesquelles des revenus reçus par des contribuables et provenant de sociétés étrangères peuvent désormais être imposés en Australie. Parmi les revenus visés, il faut noter entre autres: les bénéfices revenant à des actionnaires australiens ayant une participation importante dans une société dont le siège se trouve dans un paradis fiscal ainsi que des revenus de fonds et sociétés d'investissements étrangers. Le nouveau système prévoit également une exemption d'impôt pour les dividendes étrangers ainsi qu'une nouvelle réglementation pour les trusts étrangers. La question est de savoir si le nouveau système fiscal international annonce la disparition de l'évasion fiscale internationale. L'auteur donne son avis à ce sujet.

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Keith A. Jenkins:
La société exemptée d'impôt à Jersey 334
Entrée en vigueur au 1er janvier 1989, la "Jersey Corporation Tax Company" vient d'être abolie et remplacée par le concept de société exemptée d'impôt. Toutes les sociétés enregistrées à Jersey sont, en application de la nouvelle législation, considérées en matière fiscale comme étant résidentes à Jersey et sont soumises à l'impôt sur le revenu au taux de 20% sur leurs bénéfices mondiaux, à moins qu'elles optent pour le statut de société exemptée. Cet article commente les fondements de la "Corporation Tax Company" et analyse les dispositions de l'amendement à l'article 123 de la loi de 1961 (de Jersey) sur l'impôt sur le revenu.

Agence de Presse de Sofia:

Bulgarie: Climat favorable aux investissements étrangers 337
Le Décret no. 56 du 9 janvier 1989 du Conseil d'Etat introduit d'importantes modifications dans la structure économique bulgare ainsi que dans les conditions à remplir pour s'engager dans des activités commerciales et la coopération avec les sociétés étrangères en matière d'investissements. Cet article résume brièvement les différents aspects du Décret no. 56 traitant des investissements étrangers et les conditions commerciales applicables aux personnes physiques et sociétés étrangères.

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Robert Henrey:

U.S.A.: Internationale Steueraspekte der Geschäfte, die in ausländischer Währung ausgedrückt werden 312
Das amerikanische Steuerreformgesetz 1986 (Tax Reform Act 1986 oder TRA 86) führte insbesondere neue Regelungen (Subpart J) für Geschäfte ein, die in ausländischer Währung ausgedrückt werden. Dieser Subpart J, im Zusamenhang mit Änderungen, die vom „Technical and Miscellaneous Revenue Act of 1988" (TAMRA) durchgeführt wurden sowie mit Erläuterungen von seiten des amerikanischen Finanzamtes, bildet einen vollständigen Satz von Richtlinien für die Besteuerung von Gewinnen und Verlusten, die in einer ausländischen Währung ausgedrückt wurden. Dieser Artikel bietet eine detaillierte Analyse der neuen Regelungen. Obwohl der Autor zugibt, dass das neue Gesetz die Situation von vor dem TRA 86 erheblich verbessert hat, folgert er, dass weitere Verbesserungen notwendig sind.

U.S.A.: Gegenseitige Unterstützung: Schreiben an den Ministerialdirektor für Steuerangelegenheiten 321
Ein ad hoc Ausschuss von internationalen Steuerpraktikern schickte dem Ministerialdirektor für Steuerangelegenheiten am 9. November 1988 einen Brief, in dem die Besorgnis über die verschiedenen Aspekte des zuständigen amerikanischen Behörden-Programms zum Ausdruck gebracht wurde. Der Text dieses Briefes wird in diesem Heft abgedruckt.

Rick Krever:

Australiens neue Steuerregelungen 327
Die Vorschläge für eine weitgehende Änderung in Australiens internationalem Steuerrecht werden am 1. Juli 1990 in Kraft treten. Diese Änderungen enthalten die Einführung von Bestimmungen, unter welchen bestimmte, von ausländischen Gesellschaften bezogene Einkünfte bei australischen Steuerpflichtigen besteuert werden können. Diese Einkünfte betreffen u.a. Gewinne von in Steueroasen gegründeten Körperschaften, in denen australische Aktionäre eine wesentliche Beteiligung haben, und Einkünfte von bestimmten ausländischen Investmentfonds und Investmentgesellschaften. Das neue System wird auch eine neue Steuerbefreiung für ausländische Dividenden enthalten, sowie eine neue Regelung für das Anrechnungsverfahren ausländischer Einkünfte. Die Frage ist, ob diese neuen internationalen Steuerbestimmungen das Ende der internationalen Steuerumgehung bedeuten werden. Der Autor gibt in diesem Artikel seine Meinung.

Veranstaltungskalender 333

Keith A. Jenkins:

Die „Steuerbefreite Körperschaft in Jersey" 334
Man hat ab 1. Januar 1989 die „Jersey Corporation Tax Company" abgeschafft und durch die sogenante „steuerbefreite Körperschaft" ersetzt. Kraft des neuen Gesetzes sind alle Körperschaften, die in Jersey gegründet worden sind, in Jersey ansässig und damit unbeschränkt steuerpflichtig für die Körperschaftsteuer (20%), es sei denn, dass sie den Status der „steuerbefreiten Körperschaft" wählen. Dieser Artikel beschreibt die Hintergründe der „Corporation Tax Company" und analysiert die Bestimmungen der Änderungen zum Artikel 123 des Income Tax (Jersey) Act 1961.

Sofia Presseagentur:

Bulgarien: Ein günstiges Klima für ausländische Investoren" 337
Das Dekret Nr. 56 des Staatsrates vom 8. Januar 1989 führte radikale Änderungen in der bulgarischen Wirtschaftsstruktur ein. Auch wurden die Bedingungen, unter welchen geschäftliche Aktivitäten ausgeübt werden können und eine Investierungsteilnahme von ausländischen Körperschaften gestattet wird, grundsätzlich geändert. Dieser Artikel bietet einen kurzen Überblick der Aspekte des Dekrets Nr. 56, welche sich insbesondere mit den Investierungen aus dem Ausland und mit den Bedingungen, unter welchen ausländische Personen und Körperschaften in Bulgarien Geschäfte treiben können, beschäftigen.

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These three papers were presented at the annual meeting of the U.S. IFA Branch, held in San Francisco, California, on 13-14 February 1989.

UNITED STATES:

Working with Passive Foreign Investment Companies: How to Minimize the Hurt

Alan W. Granwell and Nancy H. Kaufman

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I. INTRODUCTION

A. Overview

The passive foreign investment company ("PFIC") provisions were added by the Tax Reform Act of 1986 (the "1986 Act").[1] The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")[2] made substantial technical and substantive amendments to the PFIC rules. Outlined below in Section II are the basic definitional rules for determining PFIC status.[3] Section III outlines the tax treatment of the direct and indirect U.S. shareholders of a PFIC. Section IV includes some ideas for avoiding PFIC status and, where necessary, living with PFIC status.

B. Background

1. Legislative history

The PFIC provisions contained in Secs. 1291 through 1296 of the Code[4], were intended to remove the economic benefit of tax deferral and the ability to convert ordinary income to capital gain which could be obtained under prior law by U.S. investors in foreign investment funds who were able to weave their way through the "pentapus", that is, the accumulated earnings tax ("AET") (Secs. 531-537); the personal holding company ("PHC") provisions (Secs. 541-547); the controlled foreign corporation ("CFC") provisions (Secs. 951-964 and 1248); the foreign personal holding company ("FPHC") provisions (Secs. 551-558); and the foreign investment company ("FIC") provisions (Secs. 1246-1247).

2. American Law Institute proposals

Many of the concepts which emerged in the PFIC provisions originated with proposals of the American Law Institute ("ALI") for the current taxation of foreign investment company income to U.S. shareholders, subject to a shareholder's election to defer tax with an interest charge. However, only corporations which were engaged, or held themselves out as being engaged, in trading stock, securities or commodities would have been covered.

1. Pub. L. 99-514, 100 Stat. 2085, 99th Cong., 2nd Sess. (22 October 1986).
2. Pub. L. 100-647, 102 Stat. 3342, 100th Cong., 2nd Sess. (10 November 1988).
3. For a thorough discussion of the PFIC provisions prior to amendment by TAMRA, see Klein and Kaufman, "Passive Foreign Investment Companies", 16 *Tax Management Int'l J.* (1987) at 223. See also Rubenfeld and Rubin, "Passive Foreign Investment Companies: The Pentapus Becomes the Sextapus, or Does It?", 36 *Tax Notes* (1987) at 199; Dale and Kaufman, "Passive Foreign Investment Companies", 18th Ann. Inst. Tax'n at 377 (1987); Klein, Granwell and Kaufman, "Passive Foreign Investment Companies Revisited", 17 *Tax Management Int'l J.* (1988) at 175; Dunn, "PFIC Rules – Tax Policy Gone Awry", 39 *Tax Notes* (2 May 1988) at 625.
4. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 ("Code"), as amended, or the regulations thereunder.

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II. DEFINITION OF A PASSIVE FOREIGN INVESTMENT COMPANY

A. General definition

A foreign corporation is a PFIC if, for any taxable year, either:
- 75% or more of its gross income consists of "passive income" (the "Income Test"), or
- at least 50% of the average value of its assets produce, or are held to produce, passive income (the "Asset Test") (Sec. 1296(a)).

PFIC status is determined without regard to how much stock is owned (separately or in the aggregate) by U.S. persons. Importantly, regulations can treat separate classes of stock or other interests in a foreign corporation as interests in separate corporations (Sec. 1297(b)(4)). For example, if a foreign corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or in other passive assets, the separate issue of stock might be treated as a separate corporation under regulations.[5] The exact scope of such regulatory authority is not entirely clear.

Note, however, that House Report (H.R.) 515 currently pending in the U.S. House of Representatives would make the Asset Test inapplicable to a foreign corporation for any taxable year in which (i) the foreign corporation is a CFC; and (ii) for the entire taxable year such CFC engages in substantial manufacturing or production activities in a foreign country which had a deficit in its balance of trade with the U.S. in the calendar year preceding the calendar year in which the taxable year begins.[6] Such amendment would apply only for purposes of applying the PFIC provisions to taxpayers that are 10% U.S. shareholders of the foreign corporation and would not apply to any Panamanian corporation for any period in which Notice 88-47 is in effect.[7]

B. Definition of passive income

1. In general

Subject to certain exceptions, "passive income" generally includes: most dividends; interest (including interest on tax-exempt obligations) and its equivalents; passive royalties and rents; annuities; net gains from assets which produce such income and from non-income producing property; net gains from certain commodity transactions; and certain foreign currency gain (Secs. 1296(b)(1), 954(c).

2. Exceptions for banks and insurance companies

(a) *Bona fide banks*
Passive income does not include income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States, or, to the extent provided in regulations, by any other corporation (Sec. 1296(b)(2)(A)). The Bluebook on the Tax Reform Act of 1986[8] states that regulations may provide circumstances in which income derived by a bank licensed to do business as a bank in the United States is not automatically excluded from passive income.[9]

(b) *Insurance companies*
Passive income does not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in the insurance business and which would be subject to tax under subchapter L if it were a domestic corporation (Sec. 1296(b)(2)(B)). The 1986 Bluebook states that the income of a bona fide insurance company is treated as non-passive income only to the extent the income would be subject to tax under subchapter L if derived by a domestic insurance company.[10] An insurance company may derive passive income where its financial reserves are in excess of the reasonable needs of its insurance business.[11] The 1986 Bluebook also states that a captive insurance company may be a PFIC if there is no risk-shifting to the foreign entity such that the company is not an insurance company.[12]

(c) *Underwriters*
The 1986 Bluebook states that bona fide underwriters of securities should be excluded from classification as PFICs both under the Asset Test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to passive income by virtue of the dealer exception in Sec. 954(c)) and under the Income Test (because a substantial amount of their income is commission income, which is not passive income).[13]

3. Related-person look-through rule

Passive income does not include interest, dividends, rents, or royalties received or accrued from a related person (within the meaning of Sec. 954(d)(3)) to the extent such amount is properly allocable under as yet unissued regulations to income of the payor which is not passive income (Sec. 1296(b)(2)(C)). The characterization of assets which produce related-person income should follow the characterization of the income.[14]

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5. See S. Rep. No. 313, 99th Cong., 2nd Sess. (1986).
6. H.R. 515, 101 Cong., 1st Sess. (1989).
7. 1988 – 16 I.R.B. 27.
8. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (Comm. Print 4 May 1987) (hereinafter "1986 Bluebook").
9. 1986 Bluebook at 1025.
10. 1986 Bluebook at 1025.
11. See H.R. Rep. No. 795, 100th Cong., 2nd Sess. (1988) at 273 (hereinafter "TAMRA House Report"); see also S. Rep. No. 445, 100th Cong., 2d Sess. (1988) at 281-285.
12. 1986 Bluebook at 1025-1026.
13. 1986 Bluebook at 1025, see Sec. 1294(b)(2).
14. TAMRA House Report at 272.

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4. Breadth of definition

The typical foreign-incorporated fund investing in stocks, securities or commodities would be a PFIC. However, many corporations with active businesses and substantial accumulated cash (whether CFCs or not) also could be classified as PFICs, even where the corporation is subject to high rates of foreign tax.

C. Assets

1. Notice 88-22[15]

Under Notice 88-22, an asset generally will be characterized as passive if it has generated, or may be reasonably expected to generate (in the reasonably foreseeable future), passive income. Assets which generate both passive and non-passive income in a taxable year generally should be treated as in part passive and in part non-passive in proportion to the relative amounts of income generated by those assets.[16] Notice 88-22 also provides guidance with respect to the characterization of certain specific types of assets.

2. Time and manner of valuation

The average value of assets is generally the average fair market value of assets (without regard to any liabilities) determined quarterly.[17] It is anticipated that the regulations, when issued, will not, in general, require fair market value to be determined by independent appraisal.[18] However, a foreign corporation may make an election to utilize the adjusted bases of its assets; once made, the election may only be revoked with consent of the Internal Revenue Service ("Service") (Sec. 1296(a)).

3. Intangibles

For purposes of determining PFIC status, a corporation's assets include intangible property, although prospectively applied regulations might provide otherwise.[19]

D. The 25% look-through rule

A foreign corporation is treated as holding directly its proportionate share of the assets of, and receiving directly its proportionate share of the income of, any corporation in which it owns directly or indirectly at least 25% (by value) of the stock (Sec. 1296 (c)). The TAMRA House Report clarifies that interest and dividends received from 25%-owned corporations are eliminated from the shareholder's income in applying the Income Test, and the stock or debt investment is eliminated in applying the Asset Test.[20] The 25% look-through rule applies with respect to indirectly held stock only if the upper-tier foreign corporation owns indirectly 25% of the lower-tier corporation's stock.[21] Under Revenue Ruling 87-90[22], the Sec. 1296(c) look-through rule can apply to cause a CFC engaged in manufacturing and which owns a PFIC subsidiary to be a PFIC.

E. 25%-owned U.S. corporations

Stock of a regular domestic C corporation, which is not a regulated investment company or a real estate investment trust, owned by a 25%-owned domestic corporation would not be treated as an asset which produces passive income or is held for the production of passive income, and income derived from such stock would not be treated as passive income, provided the foreign corporation is subject to the AET (Sec. 1297(b)(8)). If, under a treaty, the foreign corporation is not subject to the AET, the foreign corporation must agree to waive such benefit. This rule is designed to mitigate the potentially disparate treatment between U.S. individuals who hold U.S. stock through a U.S. holding company and those who hold U.S. stock through a foreign holding company.[23] In the former instance, the U.S. individual is not subject to an interest charge on distributions or dispositions of the U.S. holding company's stock.

F. Exceptions for active businesses

1. Start-up companies

A foreign corporation will not be treated as a PFIC for the first taxable year during which it has gross income if (i) no predecessor corporation (an undefined term) was a PFIC, (ii) the corporation can establish that it will not be a PFIC for either of the 2 succeeding taxable years, and (iii) the corporation is not in fact a PFIC for either of such 2 succeeding taxable years (Sec. 1297(b)(2)).

2. Corporations changing businesses

A foreign corporation will not be treated as a PFIC for any taxable year if (i) neither the corporation (nor any predecessor) was a PFIC in any prior taxable year, (ii) the corporation establishes that (a) substantially all of its passive income for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and (b) the corporation will not be a PFIC for either of the first 2 years following the taxable year, and (iii) the corporation is not in fact a PFIC during either of such 2 succeeding taxable years (Sec. 1297(b)(3)). Note, however, that a corporation may not benefit from this rule if it (or any predecessor) has ever been a PFIC.

G. Ownership of PFIC stock

1. Attribution rules

(a) *In general*

In determining stock ownership, a U.S. person is

15. 1988-11 I.R.B. 19.
16. Id.
17. Id.
18. Id.
19. Id.
20. TAMRA House Report at 268.
21. Notice 88-22, supra.
22. 1987-2 C.B. 216.
23. TAMRA House Report at 273.

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considered to own such person's proportionate share of the stock of a PFIC owned by any foreign corporation of which the U.S. person owns 50% or more (by value) of the stock, or owned by any partnership, trust, or estate of which the U.S. person is a partner or beneficiary (Sec. 1297(a)(2)(A)(3)). If the U.S. person owns any stock of a PFIC, the person is considered to own a proportionate share of any PFIC stock owned by the upper-tier PFIC (Sec. 1297(a)(2)(b)). These rules apply successively, although, except to the extent to be provided in regulations, they do not apply to treat stock owned by a U.S. person as owned by any other person, U.S. or foreign (Sec. 1297(a)(1),(4)).

(b) *U.S. partnerships*
The 1986 Bluebook provides that it may be necessary in the case of a U.S. partnership for regulations to treat stock considered to be owned by the partnership as actually owned by the partnership so as to attribute the stock to the partnership's partners.[24]

(c) *Grantor trusts*
The 1986 Bluebook clarifies that, in the case of a grantor trust, the owner of the trust under the rules of subchapter J should be treated as the owner of PFIC stock held by the grantor trust, rather than the beneficiaries.[25]

(d) *Options*
To the extent provided in as yet unissued regulations, any person with an option to acquire stock is treated as the owner of such stock (Sec. 1297(a)(4)). For this purpose, an option to acquire an option, and each one of a series of options, may be considered as an option to acquire stock. It is expected that regulations will apply this treatment, for example, where necessary to prevent avoidance of the imposition of interest.[26]

H. Continuing PFIC taint

1. General rule

Stock in a corporation is treated as stock in a PFIC if, at any time during the taxpayer's holding period for such stock, such corporation (or any predecessor) was a PFIC which was not a qualified electing fund ("QEF") (described below) (Sec. 1297(b)(1)).

2. Purging PFIC taint

(a) *Qualified electing fund election with mark-to-market election*
If a QEF election is effective after the first taxable year in the shareholder's holding period during which the foreign corporation is a PFIC, the shareholder may purge the stock of its PFIC taint by electing to recognize gain, subject to the interest-charge rules, as if such stock were sold at fair market value (Sec. 1291(b)(2)(A)).[27] The shareholder obtains a stepped-up basis and, for PFIC purposes, a new holding period (Sec. 1291(b)(2)(C); Temp. Reg. Sec. 1.1291- 10T(e)).

(b) *QEF election with CFC election*
If a QEF election is effective after the first taxable year in the shareholder's holding period during which the foreign corporation is a PFIC, and the PFIC is a CFC, the shareholder may purge the PFIC taint by electing to include in gross income as a dividend the CFC's post-1986 earnings for the period(s) the stock was held by the shareholder and the CFC was a PFIC (Sec. 1291(d)(2)(B)). Such amount is treated as an excess distribution, but is allocated only to days in the shareholder's holding period when the stock was held by the shareholder and the CFC was a PFIC (Sec. 1291(d)(2)(B)). The shareholder's stock basis is increased by the amount included in income and the shareholder obtains a new holding period (Sec. 1291(d)(2)(c)).[28] This CFC election is preferable to the mark-to-market election because gain attributable to pre-PFIC years is not required to be recognized.

(c) *PFIC ceasing to meet PFIC test*
If a PFIC ceases to meet the Income Test and Asset Test for PFIC status, the shareholder may make a mark-to-market election to recognize gain as if such stock were sold at fair market value on the last day of the last taxable year for which such corporation is a PFIC (Secs. 1297(b)(1) and 1291(d)(2)(A)). The shareholder gets a step-up in basis and a new holding period for PFIC purposes (Sec. 1291(d)(2)(C)).[29]

III. TREATMENT OF U.S. SHAREHOLDERS OF PASSIVE FOREIGN INVESTMENT COMPANIES

A. Overview

1. Policy considerations

The PFIC provisions make a major break with traditional U.S. tax policy by seeking to impose current tax, or a very rough equivalent thereof, on the U.S. shareholders of a foreign corporation without regard to whether U.S. persons control the company. There are basically 2 ways of doing so. First, by reference to the ALI proposals, deferral may be retained, but an interest charge attributable to the value of deferral may be imposed on the tax incurred on distributions and dispositions. Second, by reference to the CFC and

24. 1986 Bluebook at 1031-32.
25. 1986 Bluebook at 1032.
26. TAMRA House Report at 279.
27. See also Temp. Reg. Sec. 1.1291-IOT (issued prior to enactment of TAMRA).
28. See also TAMRA House Report at 278-279.
29. See also Temp. Reg. 1297-3T (issued prior to the enactment of TAMRA.

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FPHC provisions, the foreign corporation's earning may be included in the shareholder's income currently. The Code chose to continue deferral, subject to an interest charge, with an election out of such regime in favor of current inclusion.

2. In general

Separate rules are established for 2 types of PFICs:

(a) *Non-qualified funds*
U.S. person shareholders who do not make a timely QEF election pay tax on amounts realized with respect to PFIC stock and an interest charge based on the value of deferral.

(b) *Qualified electing funds (QEFs)*
The electing U.S. shareholders are required currently to include in gross income their pro rata share of the PFIC's earnings, with an election to defer the payment of tax, subject to an interest charge, on undistributed earnings.

B. Non-qualified funds

1. The interest charge rules

If a U.S. person shareholder of a PFIC which is not a QEF receives an "excess distribution" from, or disposes of stock of, a PFIC, the amount of such excess distribution or gain recognized on such disposition is ratably allocated to each day of the shareholder's holding period for the stock (Sec. 1291(a)(1)(A),(2)). The portion of an excess distribution or gain allocated to the period beginning with the first post-1986 taxable year for which the foreign corporation is a PFIC through the year preceding the year of the distribution or disposition ("PFIC years") is excluded from gross income, and the U.S. person's tax for the year is increased by the "deferred tax amount" (Sec. 1291(a)(1)(B),(C)). The portion allocated to pre-PFIC years and the year of the distribution or disposition is included in income as ordinary income (and may be offset by other deductions) (Sec. 1291(a)(1)(B)). Though the PFIC provisions generally apply to taxable years of foreign corporations beginning after 13 December 1986, the throw-back rules can taint distributions and gain attributable to pre-1987 earnings and result in an interest charge thereon.

2. Deferred tax and interest charge

(a) *Deferred tax amount*
The deferred tax amount is the sum of (1) the "aggregate increases in taxes" (i.e. the sum of the amounts determined by multiplying the amount of the excess distribution or gain allocated to any PFIC year by the highest rate of tax in effect for such taxable year (without regard to other income or expenses the investor may have)), and (2) the "aggregate amount of interest" of such increases in taxes (i.e. the sum of the amounts determined for each such increase in tax for the period beginning on the due date for the return for such taxable year and ending on the due date of the taxable year with or within which the distribution or disposition occurs) (Sec. 1291(c)).

(b) *The interest-charge*
The aggregate amount of interest should be treated as interest, not as a tax (Sec. 1291(c)(1)).[30] Such interest should be deductible to the extent provided under general Code rules.

3. Excess distributions

(a) *In general*
An excess distribution is any distribution in respect of PFIC stock to the extent such distribution does not exceed its ratable portion of the "total excess distribution" for such taxable year (Sec. 1291(b)(1)). A *"total excess distribution"* generally is the aggregate amount of distributions received during the taxable year in excess of 125% of the average distributions received by the shareholder with respect to the stock during the 3 preceding taxable years (Sec. 1291(b)(2)(A)). The 3-year average, however, does not include any amount previously treated as deferred earnings (i.e. that was not included in income as allocable to pre-PFIC years or the year of the distribution) (Sec. 1291(b)(2)). The total excess distribution for the taxable year in which the shareholder's holding period begins is zero (Sec. 1291(b)(2)(B)).

(b) *Observations*
Application of the interest charge to excess distributions, as well as dispositions, prevents a foreign corporation from diffusing the interest charge on dispositions by making distributions, while acknowledging that regular distributions of current earnings should not be subject to an interest charge (Sec. 1291(b)(2)(B)). However, the determination of whether there has been an excess distribution apparently is made without regard to earnings and profits. A return of capital can constitute an excess distribution.

4. Example

A foreign corporation (F) maintains its books and records on the basis of a calendar year. An individual (S) who is a U.S. person, purchases stock of F on 1 January 1986. S sells the PFIC stock on 31 December 1990 and recognizes gain of US$ 100.

(a) *Throw-back:* S's gain on the sale of his PFIC stock is ratably allocated to each day in her holding period for the stock. Thus, the gain is allocated as follows:

1986	$ 20
1987	$ 20
1988	$ 20
1989	$ 20
1990	$ 20
Total	$ 100

30. See TAMRA House Report at 268.

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(b) *Interest-charge:* S's tax and the interest charge are calculated as follows (based on certain assumed tax and interest rates):

1987:	
Deferred tax: $ 20 × .345 =	$ 6.90
Interest on $ 6.90 at 10% from 15 April 1988 to 15 April 1991:	$ 2.42
Total	$ 9.32
1988:	
Deferred tax: $ 20 × .28 =	$ 5.60
Interest on $ 5.60 at 10% from 15 April 1989 to 15 April 1991:	$ 1.24
Total	$ 6.84
1989:	
Deferred tax: $ 20 × .28 =	$ 5.60
Interest on $ 5.60 at 10% from 15 April 1990 to 15 April 1991:	$ 0.59
Total	$ 6.19

(c) *Amount treated as ordinary income:*

Pre-PFIC years	$ 20
Year of Disposition	$ 20
Total	$ 40

5. Anti-avoidance rule – non-recognition override

Regulations can be promulgated requiring gain to be recognized on an otherwise non-recognition transfer of stock in a non-qualified fund (Sec. 1291(f)). The Conference Report on TAMRA[31] states that this regulatory authority is intended to apply where necessary to prevent avoidance of the imposition of interest.[32] Thus, regulations may treat a gift of PFIC stock in a non-qualified fund to a foreign person as a disposition on which gain is recognized.[33] However, regulations might not override non-recognition in the case of a reorganization of a PFIC where a U.S. person exchanges PFIC stock for stock of another PFIC and there is no step-up in basis.[34]

6. Anti-avoidance rule – indirect distributions and dispositions

(a) *In general*
To the extent provided in as yet unissued regulations, where a U.S. person is treated as indirectly or constructively holding stock in a PFIC under the previously discussed attribution rules, any distribution in respect of the PFIC stock to the person holding such stock, and any disposition which results in the U.S. person being no longer treated as owning PFIC stock, could be treated as a distribution to, or a disposition by, the U.S. shareholder (Sec. 1297(b)(5)). This provision potentially applies to stock of a QEF, as well as stock of a non-qualified fund.

(b) *Amounts treated as previously taxed*
Regulations are also to apply rules similar to Sec. 959(b) (relating to previously taxed CFC income distributed through a chain of ownership) to the amount subject to tax under the indirect distribution and disposition rule (Sec. 1297(b)(5)(B)). For example, the TAMRA House Report states that amounts deemed distributed to a U.S. person are not to be included in the gross income (or, in the case of a QEF, earnings) of the intervening entity for purposes of causing the U.S. person to include such amounts in income again.[35]

(c) *Avoidance of imposition of interest*
The TAMRA Conference Report indicates that this provision also is intended to prevent avoidance of the imposition of interest.[36] Thus, for example, if a U.S. person owns stock in an upper-tier PFIC and a lower-tier PFIC distributes its earnings to the upper-tier PFIC annually, the TAMRA Conference Report indicates that the indirect distribution rule should not apply, unless the distribution is made available to the U.S. person.[37] However, if the lower-tier PFIC is not a QEF and the upper-tier PFIC is, then the TAMRA indicates that a disposition of the stock of the upper-tier PFIC should be treated as a disposition of stock in the lower-tier PFIC where, for example, the lower-tier PFIC has not distributed its earnings to the upper-tier PFIC annually.[38]

7. Anti-avoidance rule – carry-over basis transactions

Except to the extent inconsistent with regulations under the non-recognition override provision, regulations may provide that stock in a foreign corporation, the basis of which is determined by reference to stock of a PFIC, will be treated as PFIC stock held by the shareholder throughout such person's holding period (Secs. 1291(e), 1246(c)). The same principle would apply to other transfers (e.g. tax-free reorganizations).

8. Anti-avoidance rule – trusts and domestic corporations

Except to the extent inconsistent with regulations under the non-recognition override provisions, regulations may provide that trust certificates of a grantor trust and stock of a domestic corporation will be treated as stock of a PFIC to the extent that such trust or corporation has an investment in PFIC stock (Sec. 1291(e), 1246(d)).

9. Anti-avoidance rule – pledge of PFIC stock

Except as provided in regulations, a disposition includes the use of PFIC stock as security for a loan ("pledge rule") (Sec. 1297(b)(6)). This rule potentially

31. H.R. Rep. No. 1104, 100th Cong., 2nd Sess., Vol. 2 (1988) (hereinafter "TAMRA Conference Report").
32. TAMRA Conference Report at 10-11.
33. Id.
34. Id.
35. TAMRA House Report at 279.
36. See TAMRA Conference Report at 11.
37. Id.
38. Id.

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applies to stock of a QEF, as well as stock of a non-qualified fund (see III.C.4. below). The potential application of the pledge rule should be examined any time stock of a foreign corporation is pledged.

10. Stock acquired from a decedent

The basis of PFIC stock acquired from a decedent determined under Sec. 1014 (generally fair market value) is reduced by the excess of the basis determined under Sec. 1014 over the adjusted basis of the stock immediately before the decedent's death, unless the decedent was a non-resident alien (Secs. 1291(e), 1246(e)).

11. Foreign tax credit

Direct and indirect foreign tax credits are allowed with respect to PFIC distributions and gain treated as a dividend on a sale or exchange of CFC/PFIC stock under complex rules. In general, foreign taxes apportioned on a pro rata basis to the portion of a distribution which is not an excess distribution and the foreign taxes apportioned to an excess distribution, to the extent allocable to pre-PFIC years and the year of the distribution, are subject to the general foreign tax credit rules and, presumably, would be eligible for foreign tax credit look-through treatment. Foreign taxes apportioned to an excess distribution and allocated to each PFIC year may reduce (but not below zero) the deferred tax for such year and thereby the interest charge, subject to the separate foreign tax credit baskets and, presumably, the foreign tax credit look-through rules (where applicable). However, no carryover is allowed for such foreign taxes (Sec. 1291(g)).[39]

C. Qualified electing funds

1. Current inclusion

A U.S. person who owns, directly or indirectly, stock in a QEF is required currently to include in gross income the shareholder's pro rata share of the QEF's current earnings and profits as long-term capital gain, to the extent of the shareholder's pro rata share of the QEF's net capital gain (but not in excess of current earnings and profits), with the balance (referred to as "ordinary earnings") treated as ordinary income (Sec. 1293(a),(e)). Generally, other characteristics of the PFIC's income (e.g. source) do not pass through to the shareholder (but see Sec. 904(g)). Under the QEF rules, a year-end loss does not pass through to affect the shareholder's income.

(a) *Exception*
The ordinary earnings and net capital gain of a QEF do not include any item of income received by the PFIC if the PFIC is a CFC and the shareholder is a 10% or more shareholder of the PFIC/CFC, and the shareholder establishes that (i) such income was subject to an effective rate of foreign income tax greater than 90% of the maximum rate of U.S. corporate tax, or (ii) such income is U.S.-source income which is effectively connected with a U.S. trade or business and is not exempt from tax (or subject to a reduced rate of tax) pursuant to a U.S. treaty obligation (Sec. 1293(g)).

(b) *Earnings and profits*
The 1986 Bluebook indicates that, for purposes of calculating QEF inclusions, the characterization of income and the determination of earnings and profits generally are to be made pursuant to general Code rules.[40] However, Sec. 1293(e)(3) allows earnings and profits to be computed for income inclusion purposes by using the installment method of accounting (and the completed contract method and the LIFO inventory method, if applicable), if the PFIC uses such method to compute its income. Under Sec. 312(n)(4)-(6), the use of these methods for general earnings and profits purposes is qualified and, in the case of the installment method, prohibited. Sec. 1293(e)(3) further provides that to the extent that the use of such method in computing earnings and profits would increase earnings and profits by an amount which was previously distributed, the exception to the application of Sec. 312(n)(4)-(6) will not apply. This latter restriction prevents a current inclusion in income of an amount previously distributed and treated as a dividend at that time. For example, if there were an installment sale, earnings and profits for all purposes except QEF inclusions would be increased by the total amount of the gain. A distribution made from such earnings and profits before the gain is recognized under the installment sale rules would constitute a taxable dividend. Without the restriction prohibiting use of the installment method to calculate earnings and profits for income inclusion purposes to the extent such use would result in an increase by an amount previously distributed, such amount also would be currently included under the QEF rules in the year recognized under the installment method.[41]

(c) *Pro rata share*
Under Sec. 1293(b), pro rata share is the amount that would have been distributed in respect of the shareholder's stock if, on each day during the QEF's taxable year, the QEF had distributed to the shareholder the shareholder's pro rata share of the QEF's ordinary earnings and net capital gain for such year. However, under regulations, pro rata shares may be determined over a period other than a year (e.g. a month).[42]

(d) Distributions
If it is established that any amount distributed by a PFIC was paid out of earnings and profits which were previously included in income under the QEF provisions, the amount distributed is not treated

39. See also TAMRA House Report at 273-75.
40. 1986 Bluebook at 1029.
41. See TAMRA House Report at 276.
42. See TAMRA House Report at 275-76.

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as a dividend (Sec. 1293(c)). However, such amounts would reduce earnings and profits. The need for this latter provision arises from the differentiation between income and earnings and profits resulting from the current inclusion rule. Distributions by a QEF may be subject to the interest charge unless the PFIC was a QEF for each of its PFIC years during the taxpayer's holding period (see II.H. above for methods of purging PFIC stock of its PFIC taint). Distributions of amounts previously taxed under a QEF election would be excluded from excess distributions (Sec. 1291(b)(3)(F)).

(e) *Basis*
The basis of PFIC stock held by a U.S. person is increased by any amount which is included in the shareholder's income under the QEF provisions and is decreased by any amount distributed which is not includible in income by reason of having been previously taxed under the QEF rules (Sec. 1293(d)). Similar rules apply to adjust the basis of property on account of which a U.S. person is treated under the attribution rules as indirectly owning shares of a QEF. These rules are similar to the rules in subpart F and result from the "hopscotch" approach to QEF inclusions.

(f) *Dispositions*
If a PFIC makes a QEF election in its first PFIC year and maintains such election throughout the shareholder's holding period, any gain recognized by the shareholder on the disposition of the stock will not be subject to the interest charge rules (Secs. 1291(d)(1)(B), 1297(b)(1)). If the QEF election were made in a year subsequent to the first PFIC year in the shareholder's holding period, gain recognized on a disposition of stock would be subject to the interest charge rules, unless the shareholder made an election for the year of a QEF election to purge the PFIC taint (see II.H. above).

(g) *Preventing double inclusions*
Sec. 1293(g)(2) provides that regulations shall prescribe such adjustment to the provisions of Sec. 1293 as may be necessary to prevent the same item of income of a QEF from being included in the gross income of a U.S. person more than once.

2. Foreign tax credit

For purposes of the indirect foreign tax credit provisions of Sec. 960, any amount included in gross income under the QEF rules will be treated as if it were an inclusion under Sec. 951(a) (relating to current inclusions in income of U.S. shareholders of CFCs), and any amount excluded from gross income on account of being previously taxed under the QEF rules will be treated in the same manner as amounts excluded from gross income under Sec. 959 (Sec. 1293(f)). QEF inclusions generally are included in the foreign tax credit limitation basket for passive income, or in the case of a 10-50% owned corporation, the separate basket for non-controlled Sec. 902 corporations. However, the foreign tax credit look-through rules apply in determining the appropriate foreign tax credit limitation basket for amounts included under the QEF rules in the income of a 10% CFC shareholder (Sec. 904(d)(3)(I)). QEF inclusions may be resourced under Sec. 904(g) (Sec. 904(d)(2)(A)(ii) and (g)).

3. Making the QEF election

The QEF election generally is made by the direct or indirect U.S. shareholder for any taxable year at any time on or before the due date (including extensions) for filing such person's income tax return (Sec. 1295(b)(2)). However, a QEF election made on or before the due date, as extended, for filing the shareholder's income tax return for its taxable year beginning in 1988 will be effective retroactive to PFIC taxable years beginning after 31 December 1986, if the shareholder specifies that the election is being made for a prior taxable year and complies with the rules of Notice 88-125.[43] Notice 88-125 also sets forth the general procedures for making the QEF election. Once made, the election applies with respect to all subsequent taxable years for which the company is a PFIC unless revoked with consent of the Secretary (Sec. 1295(b)(1)). Transferees of QEF stock presumably are required to make their own QEF election.

4. Election to defer tax

A U.S. person owning shares in a QEF may elect to extend the time for payment of tax on undistributed earnings of a QEF ("1294 election") (Sec. 1294(a)(1)).[44] The election may not be made for a taxable year if any amount is includible in gross income of the shareholder with respect to the QEF stock under the FPHC or CFC provisions for such year (Sec. 1294(a)(2)). Tax deferred under the election is subject to an interest charge under Sec. 6601. The extension granted under the Sec. 1294 election terminates on the due date of the return for the taxable year in which an actual distribution is made of previously taxed earnings with respect to which the election was made (Sec. 1294(c)(1)(A)). For this purpose a loan made directly or indirectly by the QEF to the shareholder is treated as a distribution (Sec. 1294(f)).[45] When QEF stock is transferred or a PFIC ceases to be a QEF, all extensions of time to pay tax attributable to the stock transferred (or in the case of a cessation, attributable to any stock of the corporation ceasing to be a QEF) which have not expired before the date of such transfer (or cessation) generally expire on the due date for filing the income tax return for the taxable year in which the transfer of cessation occurs (Sec. 1294(c)(2)). How-

43. 1988-52 I.R.B. 4.
44. See also Temp. Reg. 1.1294-1T (issued prior to the enactment of TAMRA.
45. TAMRA House Report at 278. The TAMRA House Report also states that a loan by a QEF to a shareholder should reduce the shareholder's basis in such shareholder's stock, although such amount when actually distributed would not be included in income (see Sec. 1294(f); TAMRA House Report at 278). The purpose of this rule is not entirely clear.

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ever, regulations may provide that previous elections will not expire on account of non-recognition transactions in which the transferee succeeds to the treatment of the transferror, e.g. transfer of stock to a U.S. person on termination of a trust.[46] Note that certain of the anti-avoidance rules discussed previously could potentially trigger termination of a Sec. 1294 election (see III.B.5., 8. above).

D. Interaction with other provisions

1. Controlled foreign corporations and foreign personal holding companies

(a) *Termination of deferral for operating income*
Although directed to U.S. persons investing in foreign mutual funds, the PFIC provisions can apply to operating CFCs which accumulate earnings. The result in such instances is a termination of deferral of U.S. tax on the operating income of such corporations, which under prior law was not subject to current U.S. tax. Current taxation is effected either by imposition of the interest charge on certain distributions and on dispositions or by current inclusion of the earnings and profits of the PFIC under the QEF election.

(b) *CFC/FPHC/QEF coordination*
(i) *Non-qualified funds*
Under Sec. 1291(b)(3)(F), proper adjustment will be made to the determination of an excess distribution so as not to include any amount that is treated as previously taxed income under the CFC, FHPC or QEF provisions. However, the interest charge would apply to all of the gain on a disposition of the stock of the CFC or FHPC.

(ii) *Qualified electing funds*
Under Sec. 951(f), if an amount is included in gross income of a U.S. shareholder under both Secs. 1293 and 951(a)(1)(A)(i), then CFC (not QEF) rules apply (Sec. 951(f)). The amount of gain treated as a dividend under Sec. 1248 on the sale or exchange of stock of a QEF that is also a CFC does not include any amount previously included under the QEF rules (Sec. 1248(d)(7)). However, there is no coordination rule for other CFC inclusions (e.g. investments in U.S. property).

2. FICs

Sec. 1246 does not apply to post-1986 earnings of a PFIC which is also a FIC (Sec. 1297(b)). The 1986 Bluebook states that if a fund is subject to the interest charge rules on a disposition, as well as the FIC rules, the interest charge rules apply to treat all earnings as ordinary income and earnings from PFIC years with an interest charge.

3. AET and PHC

Neither the AET nor the PHC provisions apply to a PFIC (Secs. 532(b) and 542(c)).

4. Sec. 936

Private Letter Ruling 8844021 (5 August 1988) provides that the Sec. 936 (possessions corporation) tax credit is treated as applying to an income tax liability resulting from an inclusion in income under a QEF election (or under the CFC provisions), provided that the earnings and profits subject to taxation would qualify as qualified possession source investment income (as defined in Sec. 936(d)(2)) if actually distributed as an actual dividend.

IV. TAX PLANNING UNDER THE PFIC PROVISIONS

A. Avoiding PFIC status – active operating companies not yet PFICs

The key to avoiding the PFIC provisions is to fail both the Income and Asset Tests for PFIC status. The following suggestions for active operating companies and multinational groups might prove useful in avoiding PFIC status.

1. Income subject to CFC or FPHC provisions

Consider repatriating income subject to current tax under the CFC or FPHC provisions. This would be especially advantageous in the case of a CFC where the U.S. corporate shareholder has excess tax credits in the right "basket".

2. Tax-deferred income

Tax deferred income under the CFC provisions may be reinvested in non-passive assets producing non-passive income either directly or indirectly through 25%-owned foreign corporations or related persons with high levels of non-passive income and assets. Care must be exercised in investing such income in domestic corporations so as not to give rise to an increase in earnings invested in U.S. property under 956.

B. Living with PFICs

1. Temporary PFICS

A shareholder of an active operating company which meets the Income Test or Asset Test only temporarily might consider the QEF election. If the QEF election is in effect for each of the foreign corporation's PFIC years, the company will cease to be a QEF in the year it ceases to be a PFIC without the stock carrying the PFIC taint. If such election is timely made or is made under the special CFC election (see II.H. above), deferral for pre-PFIC earnings can be preserved without incurring an interest charge.

2. Organizational structure

To prevent the Sec. 1296(c) look-through rule from operating to treat an active operating company as a PFIC, consideration should be given to placing entities likely to be PFICs as first-tier foreign subsidiaries of U.S. corporations, rather than lower-tier foreign subsidiaries.

3. Look for PFICs

In any corporate transaction, acquisition, sale, reorganization, or liquidation, determine whether any of the subject corporations are PFICs.

46. TAMRA House Report at 278.

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UNITED STATES:

International Tax Aspects of Foreign Currency Transactions

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I. OVERVIEW

The 1986 Tax Reform Act (TRA86) specifically addressed the taxation of foreign exchange transactions in a new subpart (Subpart J) of the Internal Revenue Code (Code). This subpart, together with amendments included in the Technical Amendments and Miscellaneous Revenue Act (TAMRA) and related guidance from the Internal Revenue Service (IRS), has established new guidelines for the treatment of foreign exchange gains and losses. These are:

- *Measurement of exchange gains and losses.* All gains and losses are to be measured by reference to the functional currency of the entity carrying the transaction. This has required new definitions covering what constitutes an entity (the Qualified Business Unit (QBU) concept), and which currency is to be the functional currency of that entity.
- *Timing of recognition.* The general principle has been reaffirmed that in the case of foreign currency denominated assets and liabilities, gains and losses are recognized for tax purposes at the time of sale, exchange, repayment or redemption. However, the Code already included rules requiring that certain foreign exchange contracts be marked to market as of the last day of the taxpayer's year. Rules, the application of which can still be extremely complex, are now provided in an attempt to reconcile these 2 concepts.
- *Character of gain or loss.* The general rule is now that all foreign exchange gains and losses will be ordinary. Taxpayers who have investment motives will still be able to obtain capital treatment on certain contracts, but corporate taxpayers now have the opportunity to elect unequivocally out of capital treatment.
- *Source.* Source is an issue of primary concern to taxpayers who wish to claim a credit against U.S. tax liability for foreign taxes. The source of gain, or the source of income to which loss is allocable, is now in effect in all cases determined by reference to the location of residence of the entity carrying the foreign exchange transaction.

The law now gives the IRS broad regulatory powers to address important implementation issues. These include to what extent exchange gains and losses should be treated as interest and the complex question of how to link up transactions which are economically related to each other. The increased sophistication of the products spawned by participants in the financial markets has put pressure on the IRS and the Treasury to make use of these powers to clear up potentially troublesome questions.

A difficult issue, which is an outgrowth of the complication in the foreign tax credit limitation and the tightening up of the Subpart F rules brought about by TRA86 is that foreign exchange gains and losses are now generally characterized as Foreign Personal Holding Company Income.

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II. THE 1986 TAX REFORM ACT AND TAMRA

A. Determinations made under Subpart J

1. Application of functional currency and qualified business unit concepts

For U.S. income tax purposes, exchange gains and losses are to be computed in terms of the taxpayer's functional currency. For a U.S. company, this is the dollar. However, certain foreign operations of a branch or foreign subsidiary of a U.S. corporation are likely to have a functional currency other than the U.S. dollar if such operations are sufficient to make it a QBU. In some cases, a taxpayer may have a choice. Exchange gains and loss computed in terms of the QBU's functional currency will be the equivalent of "transaction" gains and losses as described in accounting literature.

The existence of a QBU and the determination of an appropriate functional currency issue are covered in Temporary Regulations 1.989(a)-1T and 1.985-1T. A QBU is defined as any separate and clearly identified unit of a trade or business (an independent economic enterprise carried on for profit) which maintains separate books and records. In addition, a corporation is itself a separate QBU. An individual, however, is not a QBU and will always use the dollar as functional currency.

This definition clarifies 2 issues. First, a corporation with no trade or business activities will still be considered a QBU.

Second, a corporation with one or more "trade or business" QBUs will in addition have its own "corporate" QBU. This distinction becomes relevant where QBUs within the same corporation have different functional currencies.

The dollar is the required functional currency (regardless of the currency used in keeping the books and records) where: (1) the QBU conducts its activities primarily in dollars; (2) the QBU's residence is the United States; (3) the QBU elects to use the dollar under the hyperinflationary election; or where (4) the QBU does not keep books and records in the currency in which a significant part of its activities are conducted.

The functional currency of a QBU for which the dollar is not required is the currency of the economic environment in which a significant part of the QBU's activities are conducted. This is primarily a "facts and circumstances" determination which looks to factors such as the currency of the country of residence, the denomination of the QBU's cash flows, the currency in which the QBU conducts lending or borrowing activities, generates revenues and incurs expenses.

Where a QBU has more than one currency in which a significant part of its activities are conducted, then one such currency must be chosen and used consistently. For a non-U.S. resident QBU, the GAAP functional currency will ordinarily be accepted if the determination is facts and circumstances based in a manner similar to that used above to determine a non-U.S. dollar functional currency.

The concept that a corporation has a "corporate" QBU is relevant in 2 instances. First, a U.S. corporation always has a corporate QBU with a dollar functional currency. Thus, if the U.S. corporation carries on business through a foreign QBU with the local currency as functional currency, the functional currency earnings will, when distributed, be deemed to go through the dollar functional currency corporate QBU. The corporate QBU in effect acts as a gateway which requires that an exchange gain or loss be computed as the remittance is deemed to pass out of the trade or business QBU with a local functional currency into the dollar functional currency QBU. This is because the functional currency earnings of the trade or business branch will have been subject to U.S. tax at a time when the exchange rate differs from that applicable when the earnings are remitted. Second, a foreign corporation with more than one trade or business QBU which uses different functional currencies must also account for exchange gains and losses through a single corporate QBU. In this case the corporate QBU acting as gateway will have as functional currency whichever dominates the corporation's combined activities; this will not necessarily be the dollar. The reason is similar in that earnings and profits will initially have been computed in the functional currency of each trade or business QBU. An exchange gain or loss will be determined as these earnings are deemed to flow through the corporate QBU. Needless to say the application of these concepts to cash flows between branches will create significant compliance problems.

A QBU required to use a currency other than the dollar as its functional currency may be eligible to elect the dollar as its functional currency if it operates in a hyperinflationary environment. The use of the dollar in such cases parallels the accounting rules embodied in Financial Accounting Standard Board (FASB) 52 which contemplate use of the dollar as the functional currency where there is high local inflation. This rule is important in that it recognizes the fact that long-term historic assets and their related depreciation charges disappear into financial insignificance if converted into dollars at current, as opposed to historic, exchange rates.

The hyperinflationary eligibility standard is similar to that of FASB 52 : 100% inflation over a 3-year period including the current year. In the case of a branch, the election is made with the U.S. return. Where the election involves a Controlled Foreign Company (CFC), the controlling U.S. shareholder, or the CFC itself, files a statement within 180 days of the close of the taxable year.

The hyperinflationary election includes a conformity requirement making the election effective for all QBUs that are related and meet the hyperinflationary eligibility requirements. The election is treated as an accounting method and, therefore, once made, cannot

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be changed without consent. However, no adjustment for the changes in method of accounting due to the dollar election will generally be required under Sec. 481.

The methodology for restating the financial statements of the QBU from the hyperinflationary currency into dollars is detailed in Regulations. It is referred to as the Dollar Approximate Transaction Method (DATSM). In general, the conversion is determined by using the following approach. First, a profit and loss statement is prepared in the QBU's hyperinflationary currency. Adjustments are then made to conform the statement to GAAP principles. Next, the hyperinflationary currency amounts reflected on the adjusted financial statements (both income statement and balance sheet) are converted at the average exchange rate for the period to which they relate. Thus, accounts receivable would be converted into dollars by reference to the average exchange rate applicable to the period over which the accounts receivable turn over. It would not, as under GAAP, be acceptable to use the period end rate. Finally, the resulting dollar profit and loss is adjusted to reflect any currency gain or loss resulting from the DATSM conversion.

It is unfortunate that the more practical approach of using statements prepared for GAAP purposes was not followed. This complication arises in deference to the principle that exchange differences be determined on a transaction-by-transaction basis (the realization concept). In contrast, under GAAP, all monetary items appearing in the balance sheet will be translated at the year end rate. There appears to be no sound reason why the drafters of the legislation departed from GAAP. The Regulations, however, make a reasonable attempt to minimizing through the use of average rates based on asset and liability turnover ratios the adjustments involved. The DATSM rules are in some areas reminiscent of the "net worth" approach of the old Sec. 1.964-1 Regulations.

The Regulations incorporate a major defect with respect to the disposition of the exchange gain or loss resulting from DATSM (the DATSM adjustment). The adjustment is required to be allocated to the various categories of income generated by the QBU (whether a CFC or a branch) in accordance with gross income ratios. In the case of a QBU with interest income the result can be disastrous. Nominal interest rates are extremely high in hyperinflationary economies and if the interest income of a CFC subject to inclusion under Subpart F is to be stated in accordance with economic reality it is essential to associate with it the substantial exchange loss attributable to the interest yielding investments. The rule adopted by the Regulation invariably reaches an absurd result.

2. Conversion of foreign corporation earnings and profits and foreign taxes into U.S. dollars

For purposes of determining the U.S. tax liability of a shareholder of a foreign corporation, the earnings and profits of the corporation are determined in the corporation's functional currency. These earnings and profits, if expressed in a non-dollar functional currency, are required to be converted into dollars at the "appropriate" (generally current) exchange rate on the date the amount is included in income as a result of a dividend or a Subpart F inclusion. This is a single-step conversion which in no way involves the translation of the QBU's financials.

In the case of a foreign corporation, the earnings and profits of each year are added to a "pool" denominated in the functional currency of the foreign subsidiary. This pool may have to be subdivided into separate foreign tax credit limitation categories or baskets. An actual dividend out of a functional currency pool is converted into dollars – again in a single-step transaction – at the rate prevailing at the distribution date. A similar rule applies to a gain treated as a deemed dividend under Sec. 1248. Provided that the foreign corporation's QBUs all use the same functional currency, use of the current exchange rate in these cases results in no recognition of exchange gain or loss.

A deemed distribution included in a U.S. shareholder's taxable income (i.e. as a result of Subpart F Income) is also determined by converting the relevant functional currency amount in a single step, but using the weighted average exchange for the foreign corporation's taxable year. This results in exchange gain or loss being recognized on exchange rate fluctuations between the time of a deemed distribution and the actual distribution date of such Previously Taxed Income (PTI).

Moreover, under TAMRA, amounts includible in a U.S. shareholder's taxable income as a result of an investment in U.S. property are converted into U.S. dollars at the spot rate on the last day of the taxable year. Again, this will give rise to an exchange gain or loss on the distribution of PTI.

Uniform rules are provided for converting income taxes paid in a foreign currency into dollars. The guiding principle is that the tax is converted by using the exchange rate as of the date of the actual payment of each installment. If a foreign tax is refunded, the reduction in the amount of credible tax is computed using the rate in effect when the payment was originally made. Any other adjustments to a foreign tax (e.g. an increase in the amount) is converted at the exchange rate in effect at the adjustment date. Complex rules have been set out in Regulations issued under Sec. 905 where foreign income taxes are adjusted upward and downward by reason of the distribution of earnings. Procedures are also set out for accounting for adjustments, including those which are exchange rate related, in foreign taxes where they occur before the filing of the U.S. return.

This use of historical dollar exchange rates for foreign income tax payments of foreign corporations using a non-dollar functional currency is a significant departure from prior practice (the *Bon Ami* rule) which required that taxes deemed paid be converted using the rate on the date of the actual dividend distribution. It also introduces an unwarranted hybrid methodology

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into the deemed paid credit computation, since earnings and profits pools as well as dividends are converted at the rate which is current on the dividend payment date, while the foreign income taxes and the corresponding gross-up under Sec. 78 are "frozen" at historic rates.

The impact on U.S. taxpayers of this hybrid approach is quite arbitrary in that it is generally disadvantageous where currencies are appreciating against the dollar, but absurdly advantageous in the case of subsidiaries operating in a hyperinflationary environment.

Since earnings and profits and related foreign taxes are pooled by basket for post-1986 years, the deemed paid credit for a particular dividend will eventually be made up of a large number of prorated layers of historically converted tax payments.

Unfortunately, the drafters of the legislation were unwilling to recognize that historic rates are not appropriate when taxes are associated with earnings not subject to current U.S. tax.

3. Conversion of foreign branch income into U.S. dollars

If a foreign branch of a U.S. corporation is a QBU and is eligible to use a non-dollar functional currency, it will be required to convert income or loss from the branch QBU into U.S. dollars for purposes of determining the amount subject to U.S. tax. This conversion of branch income is required to be made using what used to be described as the "profit and loss" method. Income or loss must be computed separately for each QBU in the QBU's functional currency. The resulting income or loss is then converted into U.S. dollars at the weighted average exchange rate for the taxable year. This converted amount is then included in the taxpayer's income.

Temporary Regulations provide transitional rules for branch QBUs that used the net worth method of accounting prior to 1987 and now use a functional currency other than the dollar. The need for such a rule is prompted by the result under new Sec. 987(3) that an exchange gain or loss be recognized each time a QBU remits earnings to the home office or to another QBU having a different functional currency. This gain or loss arises to the extent that the value of the currency at the time of remittance differs from the value when earned.

4. Application of Secs. 988 and 1256 to certain foreign currency transactions

All foreign exchange transactions falling within Sec. 988 of the new Subpart J benefit from the principles which clarify that gain or loss on such transactions is to be measured by reference to functional currency, that it is ordinary, and that the residence rules apply in the determination of source.

Sec. 988 transactions unequivocally include foreign currency denominated assets (loans, bonds, bank deposits, accounts receivable, currency) and liabilities (bank borrowings, notes issued, accounts payable). Almost all contracts are now within Sec. 988 (forwards, swaps, and non-listed options) and those which are not (futures and listed options) can, through an election, be brought within it.

Much of the remaining complexity relates to the fact that certain contracts can be both within Sec. 988 and Sec. 1256. The latter section provides a general rule that contracts falling within it must be marked to market by the taxpayer as of the last day of the taxable year. A contract falling within Sec. 988 only would not be marked to market. Sec. 1256 was enacted in 1981 as part of a move to prevent investors from deferring gains from one tax year to the next. Because of its broad application, Sec. 1256 has vastly complicated the rules applicable to foreign exchange contracts.

(a) *Interplay of Secs. 988 and 1256*

To understand the way in which Secs. 988 and 1256 overlap, some background on Sec. 1256 is useful. A foreign currency transaction that meets the definition of a "Section 1256 contract" is generally subject to mark to market. The definition of a "Section 1256 contract" includes contracts of the following types (as defined in Sec. 1256(g)): (i) a regulated futures, (ii) a listed non-equity option, (iii) a contract such as a forward which is *both* "traded in the interbank market" and its subject matter is one of the currencies in which positions are also traded through regulated futures contracts. There is a further condition that the contract be entered into at a price determined by reference to the interbank markets.

The definitions in (iii) are difficult to deal with in practice since the IRS has not attempted to clarify them in a comprehensive way.

It appears that the following currencies are currently the subject matter of regulated futures contracts: yen, Canadian dollar, Swiss franc, sterling, deutsche mark, French franc and the Australian dollar. Other currencies are listed as regulated futures contracts by Boards of Trade but transactions are so infrequent as to cast serious doubt as to whether they are included. Some trading in European Currency Unit (ECU) regulated futures contracts does occur and since the ECU is now generally regarded to be a currency, ECU denominated contracts appear to be within Sec. 1256.

Even more troublesome is the definition "traded in the interbank market". Strictly speaking, currency contracts such as forwards and swaps cannot be transferred or assigned without the consent of the counterparty to the agreement. This would appear to limit the extent to which they could be inventoried by dealers and also casts doubt on whether they are "traded" in the interbank market. However, it appears that there was Congressional intent to include, at the very least, forward contracts within Sec. 1256(g). The Committee Report to the amendment which extended the application of Sec. 1256 to foreign currency contracts includes its own somewhat arbitrary and not very logical definition: if the contract is entered into by the taxpayer with a financial institution it is within Sec. 1256(g).

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However, if entered into between 2 non-interbank market participants it is not (House Committee Report: P.L. 97-448, Sec. 105(c)).

Until recently, it was generally believed that currency swaps with standardized features as well as forwards were within the Sec. 1256(g) definition, particularly since the Conference Agreement to the 1986 Tax Reform Act points out that contracts with longer maturities than those which generally apply to regulated futures are within the scope of Sec. 1256. However, in Private Ruling 88-18010, the IRS ruled that swaps should properly be excluded from Sec. 1256. The ruling adopts the view that currency swaps are "significantly different" from bank forward contracts in that the former account for interest rate differentials through periodic exchanges whereas the latter account for the foreign exchange premium or discount at maturity. The logic rests on the premise that the Congress only intended to include within Sec. 1256 contracts which were "used interchangeably" with regulated futures contracts. The somewhat surprising assumption underlying the ruling is that the swaps, unlike forwards, therefore fail the test of being "traded in the interbank market". Since it is invariably advantageous to taxpayers to have a contract covered only by Sec. 988 and escape the Sec. 1256 definition, it would be ungracious to criticize a ruling designed to relieve taxpayers of the need to struggle with the latter section.

Transactions outside the scope of Sec. 1256 include currency futures traded on exchanges outside of the United States, and contracts (forwards, currency futures and currency options) that are not within Sec. 1256 because their subject matter is a currency other than one of those mentioned above.

As suggested above, it is possible for a forward contract, a currency futures, or a currency option to be *simultaneously* subject to Sec. 988 and Sec. 1256.

As originally drafted in TRA86, Sec. 988(c)(1)(B)(iii) states that a "Section 988 transaction" includes "entering into or acquiring any forward contract, futures contract, option or similar financial instrument, if such instrument is not marked to market at the close of the taxable year under Section 1256". TAMRA ruled out the last clause of the sentence, i.e.:"... if such instrument is not marked to market at the close of the taxable year under Section 1256". As a result, a forward contract involving one of the "Section 1256 currencies" described above will not only qualify as a Sec. 1256 contract but also as a "Section 988 transaction". Thus, the TAMRA amendment to Sec. 988(c)(1)(B)(iii) results in ordinary character and sourcing allocation based on residence for exchange gains and losses on forward contracts that are subject to Sec. 1256. This amendment does not automatically remove the requirement to mark to market these forward contracts. The amendment does, however, appear to minimize the impact of the *Arkansas Best* decision (described in III.A below) on forward contracts that the taxpayer intends to identify as a hedging transaction under Sec. 1256(e). The identification of a contract as a hedge under Sec. 1256(e) removes it from the mark to market rule. The amendment is thus a highly favorable development in the foreign currency area. It was apparently introduced to reduce the uncertainty created by *Arkansas Best.*

TAMRA does, however, introduce complexity since it provides a rule which would be favorable to individual investors in the event of there being a lower rate for capital gains than for ordinary income, it excludes regulated futures contracts and listed options from Sec. 988. However, TAMRA provides an out to corporate taxpayers: a new subsection, Sec. 988(c)(1)(D) provides for an election to obtain ordinary treatment and sourcing allocation based on residence for exchange gains and losses on these contracts. This election, once made, is: (1) applicable to all of the taxpayer's currency regulated futures and currency option position; and (2) irrevocable without the consent of the Commissioner. The election will be worth making to eliminate once and for all the risk of capital loss to a corporate taxpayer.

Thus, a taxpayer that makes the election can use any type of forward contract, futures contract, option or similar instrument to hedge currency exposures on transactions giving rise to foreign exchange gain or loss and be assured that the exchange gain or loss on the hedging instrument is sourced, allocated and characterized consistently with the exchange gain or loss on the hedged transactions.

(b) *Sec. 988(d) issues*

Sec. 988(d) and the Committee Reports of TRA86 address hedging transactions ("Section 988 hedging transactions") in some detail. Sec. 988(d) applies to transactions that are identified and are entered into to reduce risk of fluctuation with respect to *either* property held or to be held *or* borrowings and obligations.

It should be noted that the operation of this important rule is only to apply *to the extent provided in Regulations.* The Senate and Conference Committee Reports define 2 classes of identified hedges:

(1) *Fully-integrated*

A narrow class where several transactions are part of an integrated economic package. The economic equivalent of the integrated package could be a liability or an asset denominated in the taxpayer's functional currency, i.e. a currency borrowing swapped into dollars, or a currency note hedged into a dollar equivalent security. Under the Conference Agreement, the transactions can be integrated both into the functional currency and out of it, i.e. a dollar functional currency unit can use the rule to create a foreign currency denominated liability. Full integration will apply within the framework of the Original Issue Discount rules so that interest expense or interest income will be computed on a yield to maturity basis and in terms of the currency denomination equivalent of the package. At present the only regulatory pronouncement allowing taxpayers to use the concepts of Sec. 988(d) is Notice 87-11.

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Notice 87-11 is a lengthy document which sets out very specific and detailed conditions regarding what types of transaction can be integrated. A nonfunctional currency borrowing or investment can, through a contract or swap, be synthesized into a functional currency borrowing or investment. The Notice permits taxpayers to synthesize a functional currency borrowing or investment into a nonfunctional currency transaction. It is also possible to synthesize from a nonfunctional currency denomination into another nonfunctional currency transaction, i.e. a swap could be used by a dollar functional currency taxpayer to redominate a yen borrowing into a sterling borrowing. The conditions are rigid and there are extensive requirements regarding documentation and identification. For example, contract and maturity dates on the separate transactions must be identical, cash flows must be exactly matched and remain matched throughout the life of the transactions being synthesized, all transactions must be entered into by the same corporate entity, and a related person may not be one of the parties. The Notice does not contemplate the use of options or of other numerous techniques which could be used to achieve integration.

(2) *Partially-integrated*

With respect to transactions which are designed to limit exposure but which do not achieve perfect matching, the conference agreement directs that Regulations will provide consistent treatment with respect to character, source and timing even if *full* integration is not mandated, i.e. interest on a foreign currency liability may be fully deductible even if it has been hedged into dollars and the effective interest rate on the combined transactions is economically different. However, concern is expressed in the Committee Reports regarding possible abuses resulting from high interest rate foreign currency transactions which have been hedged. For this reason the IRS has authority to identify a hedge after the fact if the taxpayer has failed to do so and force at least a measure of integration, if this is necessary, to prevent a mismatch such as an acceleration of interest deductions. It should be noted that while Notice 87-11 makes no attempt to cover partial integration, it states that the IRS solicits taxpayer comments with respect to transactions where perfect matching (for example, with respect to maturity dates and amounts) has not been achieved. There appears to be considerable discussion within the Associate Chief Counsel's office as to how broadly the partial integration concept could be applied through the issuance of Regulations. (See discussion below regarding hedging of exposures located within foreign subsidiaries as well as the potential confusion resulting from the *Arkansas Best* discussion.)

The loss deferral rules of Sec. 1092 (and its companion Sec. 263(g), under which certain expenses may have to be capitalized) do not apply to transactions covered by the full and partial integration rules. Likewise, if transactions falling within the full or partial integration rules include Sec. 1256 contracts, such contracts will not be subject to the mark to market rules of Sec. 1256(a) nor to capital treatment (see also Sec. III-D for the limited applicability of capital treatment).

B. Treatment of certain foreign currency gains as Subpart F income

TRA86 further complicated the foreign tax credit limitation by requiring that the calculation be performed separately for the various categories (baskets) of foreign-source income. One such category is "passive" income. This category includes foreign personal holding company income ("FPHCI") earned by a CFC. The Code has redefined FPHCI in Sec. 954(c) to include the excess of foreign currency gains over losses attributable to Sec. 988 transactions, unless the foreign currency transactions are directly related to the "business needs" of the CFC. Foreign currency losses exceeding gains, however, are not FPHCI and may not reduce such income.

Additionally, income that is equivalent to interest income will be treated as FPHCI under the expanded Subpart F definition. The Regulations (Reg. Sec. 1.954(2)(T)(h)) are quite detailed as to what includes income equivalent to interest.

Under this revised definition, it is quite possible that a net foreign currency gain by a CFC could result in FPHCI which could, in turn, trigger inclusion of taxable income to the U.S. shareholder under the Subpart F rules. If such an inclusion were to occur, part or all of it could be characterized as "passive" for the purposes of determining the appropriate category or basket under the foreign tax credit limitation rule.

Temporary Regulations (Sec. 1.954-2T(g)) provide a tracing rule to exclude foreign exchange gains and losses from the definition of FPHCI under certain circumstances. These rules are unfortunately complex and because they involve an election, require careful review by taxpayers. The rules are the Treasury's response to the business needs exception included in the Code. It should be noted at the outset that the tracing concept does not apply where the hyperinflationary election is in effect. As previously discussed, this can result in highly distorted and inequitable Subpart F inclusions in the case of operations in countries such as Argentina, Brazil and Mexico.

The general rule under the tracing regulations is that an exchange gain or loss that can be associated with a Qualified Business Transaction (QBT) or which constitutes a Qualified Hedging Transaction is excluded from the computation of FPHCI.

The definition of a QBT is extremely narrow and there is no corresponding tracing rule allowing an exchange gain or loss to be associated with a transaction generating passive income. This is burdensome since in such cases a loss can never be used to offset a passive Subpart F inclusion such as interest income even though a clear economic link exists between the exchange loss and the interest income. It goes without saying that establishing what gains and losses are traceable to QBTs may impose a substantial compliance burden.

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Perhaps because of this the Regulations provide an election under which the taxpayer may give up on tracing completely and agree to characterize all exchange gains and losses as FPHCI. This so called "netting" rule may be attractive from a compliance point of view except that by making the election the taxpayer is giving up the business needs exception. Additionally, the conditions for the election are unduly severe: it applies to all related CFCs and it is binding for subsequent years.

III. SPECIAL ISSUES

A. The impact of *Arkansas Best* on foreign currency hedging transactions

The facts in *Arkansas Best v. Comm'r* did not involve foreign exchange. The taxpayer had incurred a loss on the holding of stock in a bank and based its argument for ordinary loss treatment on the so-called *Corn Products* doctrine. It is well known that the facts in *Corn Products* also did not involve foreign exchange. However, the *Corn Products* doctrine had come to be regarded as a useful label to designate any transaction as ordinary provided that it lacked investment motive and was connected with a taxpayer's business operations. In line with this approach, the Tax Court's decision in *Arkansas Best* (reversed on appeal) was based on the lack of investment purpose on the part of the taxpayer. According to the *Corn Products* doctrine, a foreign exchange transaction hedging the carrying of any asset or liability with an ordinary income flavor would, through connection with the asset or liability being hedged, be regarded as being itself an ordinary asset.

The Supreme Court appears to have now cast some doubt on the validity of making such a connection; or at least on the practice of justifying the connection by labeling it as an application of the *Corn Products* doctrine. Having departed from the Tax Court's reliance on motive and instead placing emphasis on the broad definition of the term capital asset found in Sec. 1221, the *Arkansas Best* opinion states:

> A business connection, although irrelevant to the initial determination of whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception.

The enunciation of this principle places the *Corn Products* doctrine in a potentially much more limited context, such context being whether the transaction itself could be fitted within one of the specific statutory exceptions from the general rule that all assets are capital. In deciding whether stock held in a bank was covered by one of the exceptions the Court concluded that:

> ... *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business inventory-purchase system fall within the inventory exclusion of Section 1221.

Does this rationale limit the "connection" argument to inventory or to perhaps the other statutory exceptions within Sec. 1221, for example accounts receivable? What about a contract hedging the exchange of interest rate risk on a promissory note or on a liability? The gains or the losses on the transactions being hedged are ordinary (either under Sec. 988 or because interest income and expense is involved) and yet they cannot easily be fitted within the exceptions to the Sec. 1221 definition. Such a conclusion would reject the common sense proposition that if a transaction is effective as a hedge of another transaction then the 2 transactions should offset each other in terms of their impact on the taxpayer's tax liability. It is submitted that such a principle exists independently of the *Corn Products* doctrine.

To demonstrate the absurdity of such an interpretation it is useful to consider the "hedge exception" provided in Sec. 1256(e). One of the requirements for the exception to apply is that: "... gain or loss on the transactions is treated as ordinary income or loss, ... (Section 1256(e)(2)(B))".

The term "transactions" clearly includes the contract itself. If the effect of *Arkansas Best* is to restrict the exception from the capital asset definition to "inventory-purchase system" contracts then the language in Sec. 1256(e) which refers to risk reduction with respect to "property which is held or to be held" should now be read as being limited to "inventory property" and the language referring to borrowings and obligations should be considered as inoperative.

As discussed in III.4.a. above, TAMRA has helped to reduce the uncertainty in the foreign currency area created by *Arkansas Best.* Thanks to TAMRA it will now be easier to fit a foreign exchange contract which comes within the definition of Sec. 1256 into the hedge exception as defined by Sec. 1256(e). The 1256(e) exception would prevent the application of the mark to market rule. Nevertheless, situations may still arise where *Arkansas Best* has an impact on foreign currency transactions, particularly for transactions designed to hedge operating or "balance sheet" exposures. In other words, a contract hedging such exposures may still be covered by the mark to market rule.

B. Hedging of a net investment in a foreign subsidiary

This type of hedge will generally be a transaction (almost always a foreign currency short position) booked by a U.S. taxpayer and which is designated as, and effective as, an economic hedge of a net investment in a foreign entity (see FASB 52, para. 20).

The tax treatment differs depending on what type of transaction is entered into by the U.S. taxpayer to hedge the economic exposure which is within the subsidiary. The question turns on whether the transaction falls within both Sec. 988 and Sec. 1256 or only within Sec. 988 (see discussion in II.4.a. above). If the hedge is a contract which falls within Sec. 1256 there is a risk

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that the mark to market rule will apply. It is of course possible, but far from clear, that the hedging exception of Sec. 1256(e) would be available to take the Sec. 1256 contract out of mark to market treatment. This uncertainty can probably not be avoided through the mixed straddle election under Sec. 1256(d) since an investment in a subsidiary is unlikely to be a "position" under the straddle rules.

C. Intercompany transactions denominated in foreign currency

The possible application of the loss deferral rules of Sec. 267 to transactions between a U.S. taxpayer and foreign subsidiaries raises a number of troublesome issues. Sec. 267(a)(1), because it applies to sales or exchanges of property, would appear to cover only foreign currency denominated loans from subsidiaries as opposed to amounts owed by the U.S. taxpayer. However, the old argument that the repayment of a liability can be viewed as a property transaction could still come home to haunt a taxpayer with a related party transaction. Temporary Regulations (under authority provided by Sec. 267(f)(2)(C)) were issued prior to the 1986 Tax Reform Act removing from the scope of Sec. 267 inter-company foreign currency denominated loans. However, the legislative history of the Act includes a direction to the drafters of the Regulations to review the application of Sec. 267. The General Explanation to the 1986 Tax Reform Act states: "Any Section 267 exceptions that survive this review should be narrowly drawn". The desire to limit any exceptions to Sec. 267 may be attributable to the fact that related entities often use different functional currencies with the result that a loss recognized by a U.S. lender on a loan denominated in the functional currency of the borrower would not result in an offsetting increase in the earnings and profits of the borrower. While having some basis in logic such a position does not make practical sense. It would in effect outlaw foreign currency denominated inter-company transactions. It goes without saying that a gain to the U.S. related entity would always be fully taxable.

Out of concern that a loan made to a foreign subsidiary might be denominated in a high interest-yielding foreign currency so as to generate additional foreign-source income, a special statutory recharacterization rule is provided where the rate of interest on such a loan exceeds the U.S. AFR rate by 10 percentage points (Sec. 988(a)(3)(C)).

Even outside the scope of specific statutory rules, regulatory authority is given to consider special treatment for inter-company transactions (Sec. 989(c)(5)).

D. Deductibility of foreign exchange losses

The Code contains a number of provisions designed to prevent the use of financial instruments to create or accelerate tax losses. The IRS also has considerable leeway to prevent such manipulation.

The Code, for example, states that, under Regulations, part of a foreign exchange gain or loss could be treated as interest income or expense. This could influence source as well as the computation of how much interest expense is apportioned to foreign-source income. The IRS has already used its regulatory authority in Announcement 87-57 to treat a foreign currency loss incurred by a holder of a tax-exempt bond as a reduction of the interest income earned by the holder. The Announcement is a clear sign that the IRS intends to exercise its authority to prevent the use of foreign currency transactions to create aggressively advantageous tax results.

A loss on a currency position of any type, including a contract or a liability, which is part of a straddle (i.e. there is an offsetting position outstanding in the same currency) is subject to deferral (Sec. 1092) and possibly to the expense capitalization rule of Sec. 263(g). A loss realized on a position is deferred to the extent of any unrealized gain in an offsetting position. In order to be within the scope of Sec. 1092, the property which is the subject matter of the straddle must be actively traded. The Conference Agreement stresses that this includes any currency for which there is an interbank market and is not limited to currencies which can be the subject matter of a Sec. 1256 contract.

It is unclear to what extent the IRS might, through the issuance of a Regulation, extend the wash sale rules to foreign currency transactions (Sec. 1092(b)). Temporary Regulations appear to limit its application to losses on securities.

These rules have the greatest impact on transactions entered into within the United States. They are, however, also taken into account in computing the taxable income of a foreign branch. There is an indirect effect on the amount of the credit available in the United States with respect to foreign taxes paid by foreign corporate subsidiaries since the rules influence the determination of the earnings and profits out of which dividends are paid.

E. Withholding tax issues

A long outstanding issue has been the possible liability to U.S. withholding tax in cases where payments are made under a swap to a non-U.S. counterparty. There is little doubt that periodic payments made under swaps do not constitute interest notwithstanding the fact that they are computed by reference to interest rates. Withholding has never been an issue in the case of the single exchange required under a conventional forward contract.

The uncertainty has arisen from the fact that swaps require that amounts computed by reference to interest rates be exchanged periodically and separately from amounts attributable to the stated principal of the transaction. These payments are in lieu of incorporating a premium or discount into the exchange rate at which the principal amounts will be swapped at maturity. Were such periodic amounts to be viewed as being both from U.S. sources and within the Sec. 881 definition of "fixed or determinable", withholding

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could apply in the absence of treaty protection. Few treaties provide unambiguous protection.

Unfortunately, the drafters of the Tax Reform Act declined to address the issue head on. The Conference Agreement, however, included language effectively encouraging the Treasury to look into the matter. So far timid half steps have been taken in the right direction.

The IRS has taken the position (Notice 87-4) that payments made under dollar denominated interest rate swaps will generally be sourced by reference to the residence of the recipient. Thus payments by a U.S. corporation to a foreign-based counterparty would be treated as having a foreign source and would not be taxed. The Notice does not address what character such payments might have for tax purposes and it does not cover swaps involving foreign currency. It also does not cover whether a U.S. branch of a foreign corporation (such as a foreign bank) is subject to the Notice. Finally, the IRS states in the Notice that it has taken no position with respect to whether swap income is either fixed or determinable annual or periodical (FDAP) income. Thus, while the Notice is a step forward clarifying the issue of withholding on interest rate swap payments, it leaves several questions unanswered and provides no assistance with respect to withholding on currency swap payments.

The IRS has also ruled (Revenue Ruling 87-5) that payments by a U.S. taxpayer to a Dutch bank will be treaty protected since they are part of the "industrial and commercial profits" of the recipient. While this rationale should apply to foreign currency swaps generally, the IRS appears to have deliberately narrowed its opinion to interest rate swaps and to a transaction involving a bank counter-party.

F. Impact of FAS No. 96 on foreign currency transactions

The Financial Accounting Standard Board issued in December 1987 its long awaited pronouncement on deferred taxes: Statement of Financial Accounting Standards No. 96 ("FASB 96"). The new rules require that deferred taxes be computed under the liability method. The tax consequences of earning income or incurring losses in future years cannot be anticipated for the purpose of setting up a deferred tax asset or computing the amount of a deferred tax liability. However, the deferred tax computation requires that net tax liabilities be projected for future years to the extent that they result from transactions which have *already* been recognized in financial statements. Transactions which have already been recognized for financial purposes but which are deferred for tax purposes are said to generate "temporary differences". Typical temporary differences will result from differences between book and tax depreciation, installment sales and non-tax deductible reserves.

These complex rules will have a significant impact on the tax effecting of foreign exchange gains and losses since such transactions can be expected to generate temporary differences.

Assume that an enterprise recognizes a loss in its 1988 financial statements with respect to a foreign currency denominated liability and that under the rules of Sec. 988 this same loss will not be taken into account for tax purposes until repayment which is scheduled for 1990. The loss creates a temporary difference. Tax effecting of the loss in the 1988 financials is only possible if:

(i) the loss offsets the net taxable income which is scheduled to be generated in 1990 by other transactions which have already been recognized in the financial statements;
(ii) the loss can be "carried back" (within the framework of Sec. 172(b) rules) from 1990 and offsets either:
  (a) any net taxable income scheduled to be generated in 1989 by transactions which have already been recognized in the financial statements, or
  (b) actual taxable income of 1988 or 1987; or
(iii) the loss can be "carried forward" from 1990 and offsets any net taxable income scheduled to be generated in carry-forward years by transactions which have already been recognized in the financial statements.

The above principles are to be applied in coordination with tax-planning strategies. A strategy might contemplate the earlier recognition of a foreign exchange gain or loss so as to minimize a deferred tax liability or maximize a deferred tax asset.

The computation of "temporary differences" is further complicated where a business operation is subject to tax in a foreign country based on taxable income determined in foreign currency and where that operation uses the dollar as its functional currency for financial reporting purposes.

FASB 96 preserves, at least for the time being, the long standing rule embodied in APB Opinion 23 that incremental taxes need not be provided on the eventual remittance of the undistributed earnings of foreign subsidiaries where there are plans to reinvest those earnings indefinitely.

IV. CONCLUSIONS AND RECOMMENDATIONS

The development of a set of comprehensive tax rules for dealing with foreign exchange gains and losses is the one positive aspect of the international provision enacted as part of the Tax Reform Act of 1986. The new law achieves significant and welcome improvement over the prior state of confusion. A number of difficulties nonetheless remain. Some of these are attributable to the statutory rules adopted by the drafters of the legislation. Many could, however, be cured through exercise of the very broad regulatory powers granted to the Treasury.

It is suggested that the drafters of the Regulations to be issued under Subpart J give consideration to removing a number of the pitfalls which remain. The curing

[continued on page 326]

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UNITED STATES:

Mutual Assistance Issues: Letter to the IRS Commissioner

A group of international tax practitioners have expressed their concern about various operational aspects of the U.S. Competent Authority program in a Letter to the Honorable Lawrence B. Gibbs, Commissioner of the IRS. This letter, reprinted below, outlines the reasons underlying the concern and recommends certain changes.

I. INTRODUCTION

The mutual assistance provisions in the tax treaties between the United States and most of its major trading partners reflect a long-standing recognition of the need for a mechanism to resolve international double taxation disputes and exchange tax information at the international level. We believe, however, that the use which has been made of these mutual assistance provisions in the past has been relatively modest compared to the use that will almost certainly be made of them in the next decade.

International trade and investment are growing, with foreign exports to, and investment in, the United States outpacing U.S. exports and investment abroad. It is entirely conceivable (many would say inevitable) that, within a few years, the investments made in U.S. distribution and operating facilities by Japanese, British, German and other foreign-based companies will exceed the comparable investments made by U.S. companies abroad. Regardless of the nationality or location of the ultimate owner, it is becoming increasingly common for large multinational businesses to utilize raw materials, parts, subassemblies, and technology acquired from related parties in different locations around the world in order to make products that will be sold to related parties throughout the world. Thus, flows of international business income among related entities are becoming far more multilateral than they were in the first 25 to 30 years following World War II when the United States was the dominant force in the free-world economy.

Equally significant is the decline in U.S. tax rates which has occurred in recent years. As U.S. effective rates are now lower than the effective rates in most of the other highly industrialized countries, we believe that the tax administrations of those countries are going to approach many multinational tax issues in the next 5 to 10 years with the suspicion (or even the conviction) that related enterprises are siphoning funds out of their countries into the U.S. through royalty payments, administrative fees, pricing practices and other comparable techniques, in order to benefit from the lower U.S. rates. Depending on how they are applied in practice, the new U.S. "super royalty" rules in section 482 of the Code could exacerbate this problem.

If one believes, as we do, that the principal mission of the U.S. Competent Authority is to protect U.S. taxpayers from international double taxation while maintaining a fair share of international tax revenues for the U.S. fisc, then the expansion of foreign investment in the U.S., the increasing number of international transactions between related parties, and the lowering of U.S. tax rates have clear and important implications for the Competent Authority program.

First, the *volume* of Competent Authority double taxation cases is going to increase *dramatically* in the next decade, as more foreign-initiated adjustments are made by our treaty partners.

Second, the *revenue* at stake is also going to increase *dramatically*. Instead of trying to preserve a substantial part of section 482 deficiencies proposed by IRS agents, the U.S. Competent Authority is increasingly going to be in the position of considering (and, where appropriate, resisting) adjustments proposed by foreign tax authorities that would reduce the taxable income reported by U.S. taxpayers on their returns. The emphasis is going to shift from seeking revenue gains to stemming revenue losses. Increasingly, the U.S. Competent Authority and U.S. taxpayers are going to have the same financial interest, rather than antagonistic interests as they often had in the past.

While we believe that the U.S. Competent Authority program has, in general, done a good job in the past, we frankly do not think that the Service is prepared to deal as effectively as it could or should with the next decade of Competent Authority proceedings. We believe that increased resources are going to have to be allocated to the program and that more bilateral cooperation will be necessary.

II. RECOMMENDED STRATEGIC OBJECTIVES AND SUGGESTED ACTION STEPS FOR THE U.S. COMPETENT AUTHORITY PROGRAM

In light of the increased future needs for Competent Authority assistance, we have identified four strategic objectives which we believe the Service shou!d pursue in taking actions to meet those needs. Based on these strategic objectives we have identified several specific actions which we also recommend.

First, the Service should establish a clear operating philosophy for the Competent Authority double taxation case resolution process which emphasizes the objective of avoiding double taxation wherever possible, while recognizing that it is appropriate for the U.S. fisc to maintain a fair share of international tax revenues.

Second, the Service should provide the U.S. Competent Authority program with the staffing and other resources that will be needed to deal with the changing international tax environment.

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Third, the Service should work to improve the efficiency of the Competent Authority process in the United States.

Finally, the Service, in conjunction with the Treasury Office of Tax Policy, should develop a plan for, and commit U.S. resources to, eliciting greater cooperation from foreign taxing jurisdictions with regard to the Competent Authority process.

III. ESTABLISHING A CLEAR OPERATING PHILOSOPHY FOR THE U.S. COMPETENT AUTHORITY

The U.S. Competent Authority, the Assistant Commissioner (International) has, in effect, two objectives to consider when handling double taxation cases. His first objective, arising from his status as the official designated under the provisions of a tax treaty to deal with treaty cases of double taxation, is to avoid double taxation through mutual agreement with the other treaty partner in a reasonable period of time. His second objective, arising from his status as an official of the Internal Revenue Service, is to protect the U.S. revenue. These two objectives may often conflict in the resolution of double taxation cases. What we believe is critical in establishing an operating philosophy for the U.S. Competent Authority is that revenue protection should not be given greater weight than avoiding double taxation; a balanced and reasonable approach should be preserved.

In this context, we have noted a growing tendency for the U.S. Competent Authority to dispose of double taxation cases by utilizing the foreign tax credit mechanism, rather than obtaining correlative adjustments by the treaty partners. In such cases, the principles of Rev. Ruls. 76-508 and 80-231, and the noncompulsory payment rules of Reg. Sec. 1.901-2(e)(5) are applied to treat the foreign taxes attributable to the section 482 allocation as creditable taxes. Relief from double taxation, however, depends upon the taxpayer's ability to utilize these foreign taxes under the foreign tax credit limitation rules of sections 902-904. If the section 482 adjustment involves a taxable year in which the related foreign entity paid no dividends to its U.S. parent, no credit at all will be allowable for the foreign taxes in question. Moreover, as a result of changes in the foreign tax credit limitation made by the 1986 Tax Reform Act, it will be much harder for taxpayers to utilize credits for deemed-paid foreign taxes. Therefore, in the future, "Rev. Rul. 76-508 relief" will provide even less relief from double taxation than it has in the past.

We recognize that the Competent Authority program must be reciprocal in nature, with the two governments involved being willing to compromise to avoid double taxation. We do not recommend that the U.S. Competent Authority "give away the store" and grant relief from double taxation in all unresolved cases. However, the general philosophy of the U.S. Competent Authority program should be that, to the extent possible, double taxation is to be avoided through correlative adjustments. Only in rare situations should avoidance of double taxation through the foreign tax credit mechanism be pursued, and than only as the final course of action.

Moreover, the Competent Authorities should be prepared to use correlative adjustments to avoid any double taxation that exists in fact, even if that double taxation arises as a result of inconsistent internal laws (or differing theoretical approaches) in the U.S. and foreign jurisdictions. For the reasons discussed in more detail in Annex A(1) to this letter, willingness to compromise conceptual differences as well as factual disputes is essential if the Competent Authorities are to succeed in their mission to avoid double taxation.

IV. RESOURCES SHOULD BE COMMITTED TO THE COMPETENT AUTHORITY PROGRAM SUFFICIENT IN QUALITY AND QUANTITY TO MEET THE NEEDS OF A CHANGING INTERNATIONAL TAX ENVIRONMENT

We believe that the demands on the Competent Authority program in the future will require not just more personnel, but more experienced personnel with more diverse backgrounds. It will be important to establish meaningful career paths within the Competent Authority program in order to attract and retain experienced and highly skilled professionals. Effective application of the increasingly complex laws, both U.S. and foreign, which bear on the resolution of Competent Authority cases also will require personnel with diverse backgrounds including examination skills, legal skills and economic skills.

In particular, we recommend that a number of GS-15 posts be created in the Competent Authority program to be filled by five or six country or regional "team leaders" comparable to the team leaders who were created in Appeals Offices several years ago. The goal here would be to attract seasoned Appeals Officers and international examination chiefs, who would bring to the job substantial prior experience in negotiating settlements or otherwise resolving a variety of international tax issues. Additionally, we believe the staff should include several PhD economists who could provide analytical assistance to all Competent Authority line personnel. We would hope that an upgraded emphasis on the Competent Authority program, the prospects for reasonable amounts of foreign travel, and the mission itself could be used to attract and retain highly qualified line personnel.

Most of the analysts currently handling Competent Authority double tax cases are experienced revenue agents. Because they have examination backgrounds, however, they may adopt an "examination outlook" in resolving double taxation cases. This kind of outlook makes it more difficult to achieve the balanced

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approach to relieving double taxation set out above as the appropriate operating philosophy.

Rather, the Competent Authority staff should include a mixture of attorneys, accountants and economists. While it is still important to bring in experienced field agents, attorneys from the Chief Counsel's office with international tax experience are also desirable additions to the staff. These lawyers could be attracted through a two-to-three-year "rotation program" with the guarantee that after that time they would return to the Office of the Associate Chief Counsel (International).

It would also be desirable for the analysts and lawyers to have ready access to economists experienced in section 482-type adjustments that are commonly the basis for a Competent Authority case. These economists should be assigned full time, possibly on a rotational basis, to the Competent Authority, rather than being temporarily detailed on a case-by-case basis to the Competent Authority by key districts. This would give the economists greater independence of district supervisors and relieve them of posssible pressures to support district adjustments.

Finally, it goes without saying that additional funding will be needed to meet the costs of more personnel and increasing travel. In view of the vast amounts of revenue involved, we believe that additional funding is clearly warranted. If our predictions regarding the future course of Competent Authority proceedings are correct, the Service is going to need an expandable, solidly-based and diverse organization to deal with challenges of an entirely new dimension. We think this is a case where forward planning could literally mean the difference between success and failure.

V. UNILATERAL STEPS SHOULD BE TAKEN TO IMPROVE THE EFFICIENCY OF THE COMPETENT AUTHORITY PROCESS

As the number, magnitude and complexity of Competent Authority cases increase, it becomes even more important than it is today to take all reasonable steps to expedite the processing of these cases. As statistics released by the Service show, the average Competent Authority case takes somewhere between two to three years to resolve, and it is not unusual, we understand, for a more difficult case to take five years or more. Clearly, it is desirable to assure that these processing times do not lengthen as the caseload increases; better, still, would be a reduction in those times.

We believe that a number of steps can be taken to enhance the efficiency of the processing of Competent Authority cases:

(a) The previously recommended staffing changes should help by providing a greater number of more experienced personnel to process the caseload.

(b) As noted above, we recommend the adoption of a country team approach to handling Competent Authority cases. Under this approach, one supervisor would be responsible for all cases with a number of countries. Each analyst would also be assigned to a fixed group of countries. Often the ability to effectively resolve Competent Authority cases depends upon historical knowledge of the Competent Authority program and the relationship with a particular treaty partner. Use of a team approach, where all cases involving a specific foreign jurisdiction are handled by the same group, facilitates the development and maintenance of that relationship and historic perspective. *All* cases should be handled by Competent Authority analysts in Washington, not by the Revenue Service Representatives located abroad.

(c) Use of a country team approach also will facilitate a broader use of face-to-face case resolution meetings between the case analysts from the U.S. and the treaty partner. Such meetings should be scheduled as frequently as the caseload with a particular treaty partner justifies, but in no case less often than once a year. For example, if all cases with Germany are given to several analysts, specific quarterly meetings between those analysts and the German Competent Authority and his staff could be arranged. During these meetings, cases would be divided into fact-gathering cases and cases ripe for resolution at the current or forthcoming meeting. This recommendation would probably generate more travel costs than the current system. However, we believe that experience has demonstrated the effectiveness and importance of having the analyst handling the case involved in face-to-face negotiations with the treaty partner.

(d) Procedural guidelines for the processing of Competent Authority cases should be developed by the Service on a bilateral basis with our treaty partners. This suggestion is discussed more fully below.

(e) The stated goal of the U.S. Competent Authority program should be to resolve cases within two years. Any cases not resolved within two years should be automatically submitted to a "Senior Competent Authority Review Panel" for review to determine whether all that can be done has been done to resolve the case. The panel would consist of the Commissioner, the Assistant Secretary for Tax Policy, and the IRS Chief Counsel. Ideally, as discussed in VI, below, the panel should be bilateral, but it should be established in *all* cases, even where bilateral cooperation is not achieved.

(f) The Service should issue annual statistical news releases showing the number of cases filed during the year, the number in inventory at year end, the number completed during the year, the average life span of cases in the latter two categories, and the number of completed cases where there was full relief, partial relief, or no relief, all on a country-by-country basis.

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VI. THE SERVICE, IN CONJUNCTION WITH THE TREASURY OFFICE OF TAX POLICY, SHOULD DEVELOP A PLAN FOR, AND COMMIT RESOURCES TO, ELICITING GREATER COMPETENT AUTHORITY COOPERATION FROM FOREIGN JURISDICTIONS

All of the foregoing discussion has focused on measures which the U.S. might unilaterally take to enhance the Competent Authority process. Ultimately, however, true effectiveness and efficiency for the process cannot be achieved singlehandedly – there must be cooperation from our treaty partners. Experience has shown a wide variance in the degree of cooperation and enthusiasm for the Competent Authority process on the part of our treaty partners. We believe that the U.S. should initiate and pursue a number of approaches, both bilateral and multilateral, to elicit greater cooperation from foreign jurisdictions on Competent Authority matters.

(a) The Service should seek to establish clear procedural guidelines for handling Competent Authority cases with each of our treaty partners. These guidelines, in particular, should establish time-line targets for case processing, and establish a senior review panel to handle unagreed or delinquently processed cases. A fixed time period for resolving Competent Authority double taxation cases (for example, two years) should be set and agreed upon with our various treaty partners. Exceptions to this fixed period would have to be specifically approved by each of the Competent Authorities. Also, a fixed period should be set for supplying information to support and adjustment.

For example, six months might be set for the country that has made the adjustment to gather all the facts relating to the adjustment and forward a written position paper to the treaty partner. Within a reasonable period thereafter, the respective analysts handling the case for each country would be required by the guidelines to meet in order to discuss the information supplied and determine whether any additional facts are needed. If additional facts are needed, the analysts would set a specific target date for gathering and transmitting the needed information to the treaty partner. Within a specified period thereafter, the analysts would meet again, accompanied by the Director or team leader, to negotiate the case with a view to resolving it at that time. If, within a two-year period, the Competent Authorities have not been able to resolve the double taxation in a given case, it should, with certain exceptions approved by the taxpayer, be referred automatically to the senior Competent Authority panel discussed below for resolution.

Currently, where a double-tax case has been accepted for Competent Authority consideration and the double taxation is not completely relieved through negotiation, a taxpayer's only course of action is to either (1) accept whatever relief the U.S. Competent Authority may have provided, (2) withdraw from Competent Authority and go on to Appeals, or (3) go to court. Revenue Procedures 77-16 and 82-29 provide for a Commissioner's review panel where the U.S. Competent Authority has not *accepted* a case for Competent Authority consideration. However, the panel review is not applicable where the case has been accepted, but no relief or only partial relief from double taxation is granted, or where there is no progress on a case.

To maximize the chances of resolving unagreed cases, our recommendation is to establish a senior Competent Authority panel *on a bilateral basis* made up of the U.S. Commissioner for Internal Revenue, the U.S. Assistant Secretary for Tax Policy and two officials of similar stature from the treaty partner. This approach would ensure that unagreed Competent Authority cases are considered at the highest levels by officials ultimately responsible for tax administration and tax policy in each country. The potential availability of such a panel to which unagreed Competent Authority cases will be referred should, in itself, encourage the Competent Authorities of both jurisdictions to resolve cases expeditiously at the lowest possible level.

Unlike recommendations for "arbitration panels" made up of mutually agreed upon international tax experts or third-country tax officials, which we do not endorse, the use of the suggested senior Competent Authority panel would not relinquish a country's right to ultimately determine its own taxes.

(b) The U.S. should continually seek and expand upon a dialoque with each of our treaty partners concerning specific bilateral issues, of both a technical and procedural nature, which affect the Competent Authority process. Some of the technical issues which have broad applicability to all of our treaty relationships are set out in Annex A.

(c) The U.S. should strive to reach agreement with its treaty partners regarding the procedures to be followed by related taxpayers in contesting proposed adjustments within their own countries in cases that may later be submitted to the Competent Authorities. The objectives of such an agreement should be: (1) to ensure that neither country uses proposed or potential adjustments on other issues as a club to deter taxpayers from seeking Competent Authority relief on double taxation issues; and (2) to ensure that taxpayers can not use the Competent Authority process as a means of reopening formal or informal settlements that have been made in either country. The Competent Authorities should not consider any issues not raised by the auditing agents of either country and should not agree to any adjustments falling outside the range of the adjustments proposed by those auditing agents.

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(d) The OECD Committee on Fiscal Affairs (probably Working Party No. 1) should be encouraged to undertake the development of specific and detailed guidelines for its members to adopt concerning the procedural, policy and technical issues associated with the treaty Competent Authority process. The development of a harmonized set of guidelines for the processing of Competent Authority cases, and the treatment of such matters as the waiver of the statute of limitations, the payment of interest and the authority to override domestic law, will not only advance the Competent Authority process, but will be of considerable value in an economic environment where business is simultaneously conducted in multiple jurisdictions and many treaty pairings and hence Competent Authority pairings can apply to the same multinational enterprise.

We hope the foregoing comments and recommendations may prove useful. If you or your representatives would like to discuss any aspect of our proposals, please contact Mr. Beatty, who is our coordinator. His telephone number is (202) 457–7628.

Mr. Cole, one of the Committee members listed below, is preparing a supplemental submission. His memorandum will be delivered to you in the near future over the signatures of the concurring members.

We are simultaneously sending copies of this letter to the Assistant Secretary (Tax Policy) and the Assistant Commissioner (International).

ANNEX A

Some General Technical Issues Affecting the Competent Authority Process

In the course of our consideration of the Competent Authority process we also identified several generic policy issues which impact on that process. They are discussed below from a U.S. tax perspective.

(1) *Authority to Override Domestic Internal Law:* The treaty provisions for avoiding double taxation through Competent Authority proceedings necessarily presuppose that each Competent Authority will be able to override the internal laws of its own country where necessary to reach a reasonable compromise between two competent and inconsistent internal determinations of tax liability. We understand that in recent years the Competent Authority negotiators for several foreign countries have shown an increasing reluctance to override their statutes of limitations and other internal laws. We believe that the U.S. should make a determined, high-level effort to put an end to this practice, which threatens the efficacy of the entire Competent Authority process.

The implications of this issue can be brought into sharp focus by referring to section 1059A of the Code which provides that property imported into the U.S. in a transaction between related persons may not have a U.S. income tax basis in the hands of the importer that is greater than the value placed on the property for U.S. customs purposes. Suppose that an American parent buys tractors manufactured by its subsidiary in Germany, and pays U.S. customs duties based on the intercompany selling price of $ 5,000 per tractor. The German income tax authorities later determine that the arm's length intercompany selling price for the tractors was $ 6,000 per tractor. Under traditional procedures, international double taxation would be avoided in such a case by having the U:S. and German Competent Authority representatives meet, discuss the facts, and hammer out a mutually acceptable intercompany transfer price somewhere in the range between $ 5,000 and $ 6,000 per tractor.

If, however, the U.S. Competent Authority interprets section 1059(A) as precluding any increase in the U.S. parent's cost of goods sold above the reported customs value of $ 5,000 per tractor, the Competent Authority negotiations will be doomed before they begin. Germany is obviously not going to surrender an adjustment which it regards as justifiable simply because the U.S. Competent Authority is relying on a provision of U.S. internal law that has no counterpart in Germany and is not part of the arm's length test that both the U.S. and Germany have used for years. Unless the treaty obligation to strive for the avoidance of double taxation overrides inconsistent internal laws of the contracting parties, the Competent Authority program cannot survive. Section 894(a) of the Code, as amended by the Technical and Miscellaneous Revenue Act of 1988, permits the Service to give priority to the treaty obligation in such cases, and should be interpreted accordingly. See H. Conf. Rep. No. 100-1104, 100th Cong. 2d Sess. p. 12.

(2) *Interest Issues:* In cases where a Competent Authority double taxation case is resolved in a manner that produces a deficiency in the U.S. and a refund abroad, the taxpayer will not be made whole if the foreign government allows no interest on the refund, or allows it at a rate below the U.S. deficiency interest rate. Conversely, the taxpayer will receive a windfall if the case produces a refund in the U.S. and a deficiency in a country that charges deficiency interest at an after-tax rate below the U.S. after-tax refund interest rate.

We understand that the Chief Counsel's office has issued an opinion confirming that the U.S. Competent Authority has authority to waive statutory interest on deficiencies. We urge the U.S. Competent Authority to use this authority to negotiate informal working agreements on interest with foreign Competent Authorities on a country-by-country basis.

From the taxpayer's standpoint, we believe that the fairest approach would be to agree that neither country will charge deficiency interest or allow refund interest on any Competent Authority adjustments. An alternative, which might be more palatable from a revenue standpoint, would be to charge and allow interest only for a limited number of years following the close of the taxable year at issue, or only until such time as the case is properly referred to the Competent Authority. This

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would limit a taxpayer's exposure (or windfall potential) in cases that take an unusually long time to resolve.

(3) *Exchange Rate Issues:* Where exchange rates have fluctuated markedly between the time of the transactions involved in a Competent Authority double taxation case and the resolution of the case, the primary adjustment in one country may be worth considerably more or less than the correlative adjustment in the other country if the exchange rates in effect at the time of the transactions are used to calculate both adjustments. We believe that the U.S. Competent Authority should consider the impact of exchange rates and attempt to work out appropriate relief or safeguards on a case-by-case basis.

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of these potentially troublesome questions would provide business taxpayers with greater certainty and improve the workability of the statute. The following recommendations are offered:

(1) While the criteria set out in Notice 87-11 for establishing the existence of an integrated hedge under Sec. 988(d) are helpful, it is recommended that broad guidelines be set out to deal with the practical realities of offsetting positions which are not precisely matched in terms of amounts and maturity dates.

(2) Where full integration of related transactions cannot be achieved within the criteria set out in Regulations and where interest rate or foreign exchange swaps are involved, it should be clarified that the periodic payments and receipts which occur under such swaps are items which are currently deductible and includable in the taxpayer's ordinary income.

(3) Where taxpayers enter into foreign exchange swaps and where there are counterparties who are not U.S. persons it should be clarified that the source rules operate generally so as to eliminate any withholding tax liability on payments made to a non-U.S. counterparty.

(4) Contracts which fall within Sec. 1256 and which hedge a net investment in a subsidiary or affiliate should be brought within the hedge exception of Sec. 1256(e) so long as a business motive can be established. Without clarification the rules could result in the marking to market of the contract. The *Arkansas Best* decision makes this clarification all the more urgent.

(5) The definition of a Sec. 1256 contract depends in many cases on the interpretation of the phrase "traded in the interbank market". This term should be defined so as to restrict the reach of Sec. 1256 and minimize the number of situations in which the mark to market rule might apply. The approach taken by Private Ruling 88-18010 should be expanded into a regulations project.

(6) When the taxable income or the earnings and profits of QBU such as a foreign branch or a foreign corporation are computed in terms of its foreign currency a literal interpretation of the realization requirements implies that transactions gains and losses be computed as, and only to the extent that, non-functional currency assets and liabilities are realized into the unit's functional currency. This, in many cases, results in an unrealistic and burdensome information gathering requirement. It is recommended that contrary to the position taken in Temporary Regulations, taxpayers be permitted to use the accrual principles which are followed under Generally Accepted Accounting Principles. A similar approach is also recommended for the restatement of hyperinflationary currency financial statements into dollars. The Temporary Regulations require that adjustments be made to GAAP numbers. These appear to serve no useful purpose and will have no impact on tax revenues.

(7) It is submitted that the rules of Sec. 987 (and of the Temporary Regulations) which require the recognition of gains and losses on remittances from branches are impractical and burdensome and that "basis adjustment" approach should be taken. An undue compliance burden is imposed for the sake of a theoretical approach which serves no useful tax policy.

(8) The Sec. 954(c) definition of FPHCI has been expanded to include net foreign exchange gains recognized by a CFC. This has created considerable uncertainty in that it arbitrarily raises the potential of Subpart F inclusion and passive income recharacterization. It is recommended that the "business needs" exception be interpreted more broadly than in the proposed Regulations which permit tracing. Furthermore it is urgent that the tracing principle be extended to the foreign exchange gain or loss which is computed under the hyperinflationary rules.

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AUSTRALIA:

New International Tax Regime

Rick Krever

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VI. HOW EFFECTIVE WILL THE NEW REGIME BE?

I. BACKGROUND TO THE NEW REGIME

In May 1988 the Australian Government announced a package of significant tax reforms including proposals for dramatic changes to Australia's international tax system.[1] The proposals were to take effect 14 months later, following a consultation period with the tax profession and business community.

The proposed changes were sweeping in their scope. They established a blueprint for what would have been one of the most rigourous and comprehensive international tax systems in the world – a system that many observers speculated would become a model for reform in other jurisdictions.

The key to the new international tax regime was a broad attribution system applicable to resident shareholders with interests in foreign companies resident in low tax jurisdictions. Where an Australian resident shareholder held a 10% or greater interest in such a company, an appropriate share of the company's income was to be attributed to the resident shareholder for tax purposes.[2] Complementary changes were to be made to the treatment of foreign-source dividends to integrate the operation of the attribution regime and the ordinary income tax system.

Opposition to the proposals was slow to get off the ground, probably because their release coincided with announcements on major income tax changes which were scheduled to come into effect long before the attribution system. Before the consultation process finished, however, Treasury had received a large number of written submissions objecting to various aspects of the proposals and Treasury officials had listened to vigorous criticism of their blueprint at an important seminar attended by leading tax advisers, academics and tax officials.[3]

Few commentators attacked the theoretical framework of the proposals, namely the idea of an attribution system. They did argue that their coverage was much too broad, however. In particular, critics called upon the Government to provide 2 exceptions to the attribution rules: a first one for investments in companies that were not controlled by Australian residents and a second one for investments in companies which derived predominantly active trading income from legitimate business operations in low tax jurisdictions.

The criticisms of the original proposals prompted a wide-ranging debate amongst tax practitioners and academic lawyers and economists. No definitive answers emerged from the debates and the issues were not resolved by reference to objective tax policy conclusions. Rather, they were resolved by the interplay of domestic political pragmatism and international constraints. The new, and final, blueprint was unveiled by the Treasurer in April 1989.[4] The revised proposals revealed shifts by the Government in respect of the 2 principal issues that concerned critics of its original proposals. The Government had adopted both a control rule and an active business exemption. The result is an interesting amalgam of features from the world's existing 7 foreign income attribution systems, in the United States, Canada, the United Kingdom, France, the Federal Republic of Germany, Japan and New Zealand.[5]

1. The proposals were set out in Australian Treasury, Taxation of Foreign Source Income: A Consultative Document (Canberra: A.G.P.S., 1988).
2. A detailed description of the proposals may be found in R. Vincent, "Australia: Taxation of Foreign-Source Income", 42 *Bulletin for International Fiscal Documentation* 11 (1988) at 493.
3. The seminar was organized by the Taxation Business and Investment Centre of the Faculty of Law at the University of New South Wales. Selected papers from the seminar appear in 5 *Australian Tax Forum* No. 4 (1988) and 6 *Australian Tax Forum* No. 1 (1989).
4. Treasury, Taxation of Foreign Source Income – An Information Paper (Canberra: A.G.P.S., 1989).
5. For a comprehensive description of these systems (apart from New Zealand's, which was adopted subsequently), see B. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto: Canadian Tax Foundation, 1986). See also International Fiscal Association, Taxation of Domestic Shareholders on Undistributed Income of Foreign Corporate Affiliates: Objectives, Techniques and Consequences (Deventer: Kluwer, 1987). For details of the New Zealand system, see New Zealand, Consultative Committee on Full Imputation and International Tax Reform, International Tax Reform, Part I: Report of the Consultative Committee (Wellington, March 1988) and International Tax Reform and Full Imputation, Part 2: Report of the Consultative Committee (Wellington, July 1988).

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The final package consists of 4 separate, but closely integrated elements. These are: (1) the adoption of a controlled foreign company attribution system; (2) a foreign passive investment fund attribution system; (3) a new dividend exemption and foreign tax credit system; and (4) a new grantor trust attribution system, applicable to foreign trusts only.

II. THE CONTROLLED FOREIGN COMPANY ATTRIBUTION SYSTEM

The foreign income attribution system consists of 4 basic elements. The basic attribution rule is simple: a proportional share of income derived by companies resident in low tax jurisdictions is attributed to substantial Australian shareholders for domestic tax purposes. Complementary changes to the taxation of foreign-source dividends ensure these profits will be free of further Australian tax when repatriated to Australia. The attribution rules are subject to an exemption for income derived by a non-resident company that is not a controlled foreign company and for a non-resident company that derives predominantly active business income.

A. Substantial Australian shareholders

Only residents with substantial interests in foreign companies are potentially subject to the controlled foreign company attribution system. Substantial interests are defined as 10% or greater interests in a foreign company, measured in terms of the greatest of shareholdings, voting rights, rights to dividends or rights to distributions upon winding up. The right or ability to acquire any of these listed rights or powers (for example, by ownership of options or convertible instruments) will be treated as ownership of the underlying rights or powers.

The 10% threshold was chosen as the point where a shareholder should have sufficient influence in a company to obtain the financial information needed to recompute the foreign company's income for Australian attribution purposes. Constructive ownership provisions will group the holdings of related parties for the purpose of identifying substantial shareholders.

B. Comparable tax countries

The Government's original attribution proposals were to apply to income derived by companies resident in designated low tax jurisdictions. It was anticipated that about 50 jurisdictions would be identified in this fashion, leaving approximately 160 countries on the potentially exempt list. This strategy was reversed in the final proposals and the new system will operate by reference to a list of designated comparable tax countries (about 60).

The original proposals characterized countries as comparable tax jurisdictions or low tax jurisdictions in the first instance by reference to their nominal company tax rate (the tax base, too, was taken into account, of course). The threshold separating comparable tax and low tax jurisdictions was a 25% company tax rate. This test has been retained in the shift from designating low tax jurisdictions to designating comparable tax jurisdictions.

The 25% rate is apparently generous in the context of an Australian company tax rate of 39%. It was allegedly chosen originally to ensure that New Zealand, which then imposed a company tax rate of 28%, would not appear on the list of designated low tax jurisdictions. New Zealand has since raised its company tax rate to 33%, but the criterion has not changed.

The change to a list of designated comparable tax jurisdictions rather than a list of low tax jurisdictions is explicable on a number of grounds. The administrative burden of maintaining an accurate low tax jurisdiction list was a principal reason for the change. To ensure the integrity of the controlled foreign company regime, tax officials would have to monitor continually the large number of countries that did not appear on the low tax jurisdiction list to see whether their tax systems contained preferences or exemptions that Australian residents could exploit while avoiding the attribution rules. The enormity of such a task was beyond the limited resources of the Australian Taxation Office. In many cases, Australia has limited ties with countries that were not on the designated low tax jurisdiction list and little information on their tax systems is readily available to tax officials. Concern was also expressed over language difficulties in many instances.

Finally, Treasury officials concluded that omissions from a comparable tax jurisdiction list would be less likely to cause harm than omissions from a list of low tax jurisdictions. Where qualifying countries have been inadvertently left off the comparable tax jurisdiction list or where non-qualifying countries alter their tax systems in such a manner that would qualify them for inclusion on the list, it can be expected that taxpayers with interests in those countries will bring these facts to the attention of Treasury officials and help assemble the facts necessary to support their case. On the other hand, Treasury officials are confident of their ability to keep track of the tax systems of countries on the list, given that many are treaty partners (all treaty partners appear on the list) and many of the rest maintain close ties with Australia.

C. The control rule

The Government's original foreign income attribution proposals adopted a very strict formula for designating taxpayers to whom the attribution rules applied – any taxpayer with a substantial interest (that is, a 10% or greater interest) in a company resident in a low tax jurisdiction was subject to attribution.

The approach adopted by the Government was in line with that proposed in December 1987 by New Zealand for its foreign income attribution system. (The New

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Zealand proposals were substantially modified shortly before the release of the Australian proposals.) It deviated from international norms since most countries applying attribution rules do so only where the foreign company is "controlled" by residents (France being an exception, applying its attribution rules where French residents have a substantial interest – at least 25% ownership – in the foreign company).

Critics argued that a control rule was necessary to ensure resident taxpayers could act in concert to compel a foreign company to provide them with the financial information they required to comply with the attribution rules. The criticism provoked some debate. Supporters of the original proposals pointed out that the 10% threshold was used for other international tax purposes – for example, for access to credits for underlying taxes under the foreign tax credit system. As was the case with foreign tax credits, they argued, taxpayers unable to obtain the necessary information were free to switch investments.

Supporters also argued that a control rule invited avoidance of the attribution system by the simple expedient of lowering Australian interests in the foreign company to less than 50%. They pointed out that technically a single shareholder with a 49% interest in a foreign company could avoid the rules so long as the remaining shareholders were non-residents.

Critics of the proposals countered that access to foreign tax credits was far different from access to information needed to complete a tax return. To begin with, they explained, the information required for foreign tax credit purposes was much less than information needed to recompute a foreign company's income according to Australian tax rules for the purpose of attribution. Also, they noted, the consequences of failure to obtain the information was very different. In the absence of adequate information, the worst risk run by a person seeking foreign tax credits was a loss of the potential credits if and when profits were repatriated to Australia. By way of contrast, a taxpayer who failed to complete a return as required by the attribution rules would be subject to severe penalties.

The critics were persuasive and in the final proposals the Government retreated from its strict 10% threshold to a 10% threshold combined with a control rule. The control rule differs from those used in most other jurisdictions that have adopted foreign income attribution systems by treating a 50% or greater ownership interest as a controlling interest. The definition is similar to that eventually adopted by New Zealand, when it retreated from its original attribution proposals. All other countries with foreign income attribution systems, except France, define control as greater than 50%. The Australian rule is intended to catch joint ventures that would otherwise fall outside the attribution system.

Control may be established by applying either of 2 alternative tests. The first is a strict legal test which makes reference to voting rights and rights to distributions. The second test is a de facto economic control test and takes into account situations in which a minority shareholder can determine or influence company policy as would be the case, for example, where a minority shareholder has the power to veto decisions of the majority shareholders or the minority shareholder can determine the composition of the board of directors. A minority shareholder might also exercise de facto economic control where the remaining shareholdings are widely held or held by shareholders who do not wish to influence directly company policy as could be the case, for example, if the other shareholders were life insurance companies or pension funds.

The measurement of control is subject to an important restriction in that control is defined in terms of the interests of 5 or fewer shareholders. Only Canada and New Zealand adopt a similar approach. The United States also adopts a 5 or fewer rule for its foreign personal holding company provisions, but the general attribution system (known as the Subpart F rules) considers all shareholders with interests at or above a specified threshold, namely 10%. Australian authorities concluded that a rule which measured control only in terms of the shareholdings of persons above a specified threshold would be easy to avoid by the simple expediency of reducing individual shareholdings below that threshold. The Australian 5 or fewer shareholders rule was seen as a reasonable compromise between a system looking at the interests of all resident shareholders (as is the case in Japan, for example) and one which only took into account the interests of substantial shareholders.

D. Active income exemption

The feature of the original attribution proposals which generated the most criticism and the most intensive lobbying by parties who would be subject to the proposed rules was its universal application to all income derived by companies resident in low tax jurisdictions. With the exception of New Zealand, no other country has adopted such a comprehensive regime; all other attribution systems contain an exemption for active business income derived by companies engaging in legitimate trading or business operations.

Critics of the original proposals argued that, in the absence of international norms imposing attribution systems on all sorts of income derived by subsidiaries in low tax jurisdictions, Australia should not proceed alone with such an initiative. (The New Zealand exception was not considered sufficient to undermine the basic thrust of the argument.) If it did, critics claimed, legitimate Australian business ventures in countries other than the limited list of comparable tax jurisdictions would be rendered uncompetitive. The argument presumed that other investors in low tax jurisdictions, seeking a given after-tax rate of return, had priced their products and services to take account of the low or non-existent taxes. Australian investors, on the other hand, would be subject to domestic taxation on income derived by their low tax subsidiaries and would require higher pre-tax rates of return.

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Supporters of the original proposals rejected the competitive justification for an active business exemption, arguing that the position of Australian owned firms in low tax jurisdictions relative to other companies in the same jurisdictions was not the relevant comparison. Instead, they argued, the proper comparison was between Australian owned companies resident in low tax jurisdictions and Australian owned companies resident in Australia. The effect of not subjecting shareholders of the former to attribution taxation, it was suggested, was to subsidize their operations compared to their Australian resident counterparts.

The Government found the arguments mounted by the critics of the original proposals to be persuasive. It concluded that Australian business investments in many jurisdictions would be hurt by the attribution system and that a reasonable portion of that investment was neither tax driven nor aimed primarily at the avoidance of Australian taxes. The solution, it agreed, was the adoption of an active business income exemption to the attribution rules.

Treasury officials charged with designing the active income exemption considered 2 models for the exemption: a transactional system in which designated active business derived by all controlled foreign companies resident in low tax jurisdiction would be exempt from attribution, and an entity system in which all income of companies deriving predominantly active business income would be exempt from attribution and all income of companies deriving an insufficient proportion of active business income would be subject to attribution. They opted for the latter approach after concluding it presented far less compliance difficulties for taxpayers.

Having chosen to make the active business exemption available on an entity-by-entity basis, Treasury officials then had to decide how to identify companies deriving sufficient active business income to qualify for an exemption. Two other countries provide entity-by-entity exemptions from their attribution rules, Japan and the United Kingdom. In both cases, tax authorities are given a fairly broad discretion in allowing the exemption, after taking into account a wide range of factors. Australian authorities concluded this approach was inappropriate in Australia's case and sought to devise a more objective test, based on the presence of a permanent establishment in the country of residence and an acceptable percentage of a company's income being of an active business nature. Given the fact that the adoption of an entity-by-entity exemption meant that some investment income derived by exempt companies would escape the attribution rules, Treasury officials chose a high qualifying threshold and limited the exemption to companies whose incomes were at least 95% active business income.

Treasury officials charged with the task of preparing a comprehensive definition of active business income turned to the German, Canadian and U.S. precedents, all of which were devised for exemption systems that operated by reference to income type rather than percentages of different classes of income. The U.S. model proved to be the most appropriate for Australian needs and the final approach adopted is based to a large extent on the U.S. definition. The U.S. provision provides a negative definition of active business income – it is income that is not tainted income. Tainted income, in turn, is described in detail. The definition is designed to catch all types of income which are likely to be derived in a low tax jurisdiction for tax reasons rather than for legitimate business reasons.

Tainted income includes most types of passive investment income (interest, dividends, royalties, licensing fees, etc.) and income which is likely to be the product of a transfer pricing arrangement, that is, income from transactions with parties related to Australian residents.

III. THE FOREIGN PASSIVE INVESTMENT FUND ATTRIBUTION SYSTEM

The original Australian attribution proposals contained only one important threshold, the 10% or greater substantial interest threshold. Any threshold establishes a limit to the effectiveness of a provision, however, and it was reasonable to presume that astute taxpayers would ensure their shareholdings fell below the trigger figure to avoid the attribution rules. Overseas experience showed this to be inevitable – all 7 countries utilizing some sort of foreign income attribution system had encountered the problem and all but Japan and France had devised special regimes to contain the problem.

If the need for a supplementary anti-avoidance system was pressing in the context of the original proposals, it was acute in the context of a controlled foreign company attribution system in which taxpayers were outside the system completely so long as the company was not controlled by Australian residents. As explained earlier, a taxpayer with a 49% interest in a company could escape the system so long as the remaining 51% were controlled by non-residents.

The proposed solution to this problem is the establishment of a passive investment fund system under which an appropriate share of income derived by foreign passive investment funds will be attributed to Australian investors with interests in the funds, regardless of the percentage ownership interest held by the investors or the jurisdiction of "controlling" shareholders.

At this point no details of the proposed passive investment fund regime have been released. The proposed title for the system and the brief description found in the close of the documentation setting out the controlled foreign company system suggest that the system will apply to both companies and analogous entities including unit trusts. At the same time, it seems likely that not all investments in foreign entities will be caught under the new rules. It is probable that the new system will apply only to interests in entities deriving a relatively narrow class of passive investment income.

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IV. THE DIVIDEND EXEMPTION AND FOREIGN TAX CREDIT SYSTEM

It was only in 1987 that Australia adopted a comprehensive foreign tax credit system. Compared to many overseas models, the Australian system was relatively simple. All taxpayers could seek foreign tax credits for taxes imposed directly on dividends, that is withholding taxes. In addition, company shareholders with a 10% or greater interest in a foreign company were entitled to credits for foreign underlying taxes imposed on the company making a dividend distribution.

Foreign tax credits could only be used to offset taxes on foreign-source income and could not be applied to offset taxes on domestic-source income. For the purpose of matching foreign tax credits and taxable foreign-source income, foreign-source income was allocated into 2 baskets – foreign-source income other than interest and foreign-source interest income. Credits from taxes imposed on income in one basket could not be used to offset Australian taxes on income in the other basket. The division was made to discourage taxpayers from investing in interest bearing instruments via tax haven subsidiaries only to absorb excess foreign tax credits they may have accumulated in other jurisdictions.

In May 1988 the Government announced a reduction in the company tax rate from 49% to 39%. On its face, the new rate was not out of line with new company tax rates imposed by many of Australia's trading partners. The Australian tax was a final rate, however – unlike many other jurisdictions, Australia imposed no separate state, provincial or municipal income taxes and no other profit based taxes such as social security levies, pension levies, unemployment insurance rates, etc. The effect of the rate reduction was to ensure that creditable foreign taxes in many jurisdictions would exceed Australian taxes imposed on profits repatriated from those jurisdictions. As a result, considerable pressure was put on Australia's foreign tax credit baskets, as taxpayers sought to redirect sufficient profits to low tax jurisdictions in order to absorb excess credits from taxes in higher tax jurisdictions.

Two possible responses were open to the Government. One was to replace the world-wide foreign credit and income basket system with a country-by-country system. The second alternative was simply to exempt from Australian taxation dividends from comparable tax countries. Overseas experience showed the first choice was fraught with enormous administrative complications and Treasury officials opted for the second choice. The effect of this system is cause taxpayers to "lose" the value of all foreign taxes in excess of Australian taxes that would have otherwise been levied on dividends.

The new exemption system will come into effect on 1 July 1990. Anti-avoidance provisions will prevent taxpayers from diverting income from low tax jurisdictions to comparable tax countries prior to that date for later repatriation to Australia after the exemption system is in place.

The exemption will be available to company shareholders with non-portfolio interests in companies resident in comparable tax countries. A non-portfolio interest is defined as a 10% or greater voting interest in a company. Comparable tax jurisdictions are determined by reference to the list developed for the controlled foreign company attribution system. If a subsidiary is exempt from the controlled foreign company regime by virtue of its residency in a comparable tax jurisdiction, dividends it pays to Australian shareholders will be exempt from Australian taxation. Individual shareholders and company shareholders with portfolio interests (less than 10% voting interests) in companies resident in comparable tax jurisdictions will not qualify for the exemption. Instead, dividends they receive will be assessable and eligible for credit for withholding taxes (but not underlying taxes) under the ordinary foreign tax credit system.

The comparable tax jurisdiction list was determined by reference to a 25% company tax rate threshold. In theory, this means a tax saving can be realized by companies with subsidiaries in jurisdictions levying company taxes from 25% to 39%, which would offset in part the overtaxation (from an Australian perspective) of profits from countries with tax rates above 39%.

In addition to the exemption for dividends from listed comparable tax country companies, there are a number of supplementary exemptions available to non-portfolio shareholders in companies resident in unlisted countries. The most important of these is the exemption for dividends paid from income that was previously attributed to the shareholder for tax purposes under the controlled foreign company regime. This exemption is available for income derived directly by the company paying the dividend and for income derived by a lower tier subsidiary and received by the higher tier company as a dividend. A further exemption applies to dividends from companies in non-listed countries to the extent they are comprised of income derived from branches in listed countries or of dividends received from companies in listed countries (whether received directly by the company paying the dividend or flowing through other companies in unlisted jurisdictions first).

In theory, after all exemptions are taken into account, the only non-exempt dividends received by a company shareholder with a non-portfolio interest in the paying company will be those paid from income derived in an unlisted country and not previously attributed to the shareholder for tax purposes. Income could escape attribution either because the paying company qualified for the active business income exemption or because the paying company was not a controlled foreign company.

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V. THE GRANTOR'S FOREIGN TRUST ATTRIBUTION SYSTEM

Australian taxation authorities believe a significant amount of foreign investment by residents is conducted through non-resident trusts, although the conclusion is based on anecdotal evidence and no figures are available. Since trusts can substitute for companies in most instances, proposals for a controlled foreign company attribution system can only be contemplated if corresponding measures are adopted for trusts.

Although it is not spelled out in the documents outlining the new system, it appears the passive investment fund attribution system described in part III, above, will extend to investments in non-resident unit trusts and similar fixed interest foreign investment trusts. The passive investment fund attribution system cannot, however, apply to discretionary trusts, since there is no beneficiary to whom accumulating income can be attributed in the case of a discretionary trust. Under current legislation, potential beneficiaries of discretionary trusts are taxed when and if they become entitled to distributions from the trust. There are no provisions to recapture the considerable deferral advantages that are enjoyed while income accumulates free of Australian taxes in a foreign jurisdiction.

The proposed solution to this problem is an attribution system directed at a "transferor" to a non-resident discretionary trust. The new term "transferor" has been employed in preference to traditional trust law terminology such as settlor to ensure residents cannot avoid attribution by contributing to a foreign fund established by another person. Transferor will be defined to include persons who directly or indirectly transfer value to a non-resident trust. Indirect transfers include provision of goods or services on a non-arm's length basis (i.e. for less than market value).

Two difficulties are encountered in the case of discretionary trust attribution provisions which do not arise in the context of the controlled foreign company regime. The first is the possibility that resident transferors may not be able to obtain financial information from foreign trustees, given the theoretical lack of a relationship between the transferors and the trust. In these circumstances, tax officials will attribute to the transferor an income flow calculated by reference to an imputed rate of return equal to 5 percentage points above the long-term bond rate.

A second difficulty with the discretionary trust attribution system is the fact that attribution cannot apply if the transferor no longer exists. This could occur, for example, when a transferor dies (or makes a testamentary transfer) or, in the case of a company transferor, when the transferor winds up. In these cases there will be no attribution to Australian residents of income accumulating in foreign trusts. However, if and when resident beneficiaries receive distributions from those trusts, they will be subject to an "additional tax" intended to act as an interest charge for the benefits of tax deferral enjoyed while the income accumulated free of Australian taxes.

The new rules will apply to all transfers made after April 1989, the date of release of the information paper setting out the new attribution rules. Previously existing trusts to which no further contributions are made will also be subject to those rules if it can be shown that a resident transferor retains some "control" over the trust. Control is broadly defined to include any case where a trustee is under any formal or informal obligations to heed the wishes or interests of the transferor when determining trust distributions.

Taxpayers establishing non-resident discretionary trusts after April 1989 will do so knowing of their personal tax liabilities and will be able to structure the transfer in a manner that ensures they will have access to adequate funds to satisfy their tax obligations. The Government recognized that the application of the new rules to existing trusts could cause some hardship in cases where transferors exerted some control over the trusts, as broadly defined, but were not in a position to command access to the trusts' income or corpus. Accordingly, it has provided a concessional rule to enable such persons to wind up previously established trusts prior to the date at which the new system comes into effect. Income from previously existing discretionary trusts distributed to beneficiaries prior to the commencement of the transferor's 1990-91 tax year will qualify for a special tax rate of 10%.

VI. HOW EFFECTIVE WILL THE NEW REGIME BE?

Policy constraints have shaped a less than comprehensive new international tax regime for Australia. Concessions for shareholdings below the 10% level, for investments in foreign companies not controlled by residents, and for investments in foreign companies deriving predominantly active business income have defined the boundaries of the new attribution system. Tax minimization will be curtailed, but not eliminated. It will also become more complex and more costly as tax advisers work to test the limits of the new system.

It will be some time before the final effect of the new rules can be determined. Much will turn on the structure of the yet to be designed foreign passive income fund system. But to be fully effective, the passive income fund rules will have to duplicate the controlled foreign company attribution system apart from the minimal holding threshold and control rule. If they were to do so, of course, the controlled foreign company system would be completely redundant – for this reason alone it is safe to conclude that the passive investment fund system will be aimed only at a small percentage of those taxpayers who slip through the controlled foreign company net.

Most importantly, passive investment income to which the investment fund system is likely to apply will be defined in a far narrower manner than is tainted income, which underlies the controlled foreign company system. It is inevitable that taxpayers will seek to

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exploit the difference between the 2 definitions by deriving through entities that fall outside the definition of a controlled foreign company income types which are not encompassed in the concept of passive investment income subject to the passive investment fund regime. Meanwhile, investors who retain substantial interests in controlled foreign companies will concentrate their efforts on restructuring transactions to convert tainted income into active business income.

The result of all this is likely to be the start of a long process of action and reaction. The new international tax system will not herald the end of international tax avoidance. Rather, it will signal a shift of the international tax planning game into a new phase, one which will involve a process of continual taxpayer experimentation, tax assessor challenge and consequent adjustment of taxpayer practice or tax legislation, as the case may be. The lack of certainty is the price to be paid for the unavoidable concessions around which the new system was designed. In this respect Australia will follow in the footsteps of earlier pioneers who today are still adjusting the details of their attribution rules developed years ago.

Conference Diary

AUGUST 1989

45th Congress International Institute of Public Finance, on Public Finance and Steady Economic Growth. Buenos Aires, 28-31 August (English):
International Institute of Public Finance, General Secretariat, University of Saarland, D-6600 Saarbrücken 11, West Germany.

SEPTEMBER 1989

Joint Seminar of the U.S. and British Branches of I.F.A. prior to the RIO Congress. Coral Gables. Miami, 7-8 September (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

I.T.P.A. Workshop. Monte-Carlo, 14-15 September (English):
To: Elisabeth Walters, Conference Director, International Tax Planning Association, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

43rd IFA Congress: Rio de Janeiro, Brazil, 10-15 September 1989.
Subject I: Disregarding a Legal Entity for Tax Purposes.
Subject II: Administrative and Compliance Costs of Taxation.
Seminar A: Taxation of Services as Rendered Internationally as Opposed to Technical Assistance or Industrial Licence Agreements.
Seminar B: Tax Treaties and Domestic Legislation.
Seminar C: Turnkey Jobs.
Seminar D: Taxation Systems of the South American Common Market.
International Fiscal Association, World Trade Centre, P.O. Box 30215, 3001 DE Rotterdam.

Fundamental Elements of U.S. Federal Taxation; U.S. / International Taxation; U.S. Individual / Expatriate Taxation. Lésigny, 18-23 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London, WIM 5FT, United Kingdom.

Praktiker-Seminar zur Steuerreform 1990. Wiesbaden, 22 September; Stuttgart, 23 September; München, 29 September; Würzburg, 30 September (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

NOVEMBER 1989

The 12th Annual Congress of the American Tax Institute in Europe: New Developments in U.S.-European Taxation. Cannes, 13-15 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

I.T.P.A. Seminar. Palm Beach, 20-21 November (English):
Ms. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 65Z, United Kingdom.

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

DECEMBER 1989

Fundamental Elements of U.S. Federal Taxation. U.S. / International Taxation: Tax Strategies for Cross Border Activities; U.S. Taxation: Oil and Gas – Including International Aspects. United Kingdom, 4-9 December (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London WIM 5FT, U.K. Telephone (1) 935 7502, telefax (1) 935 1308.

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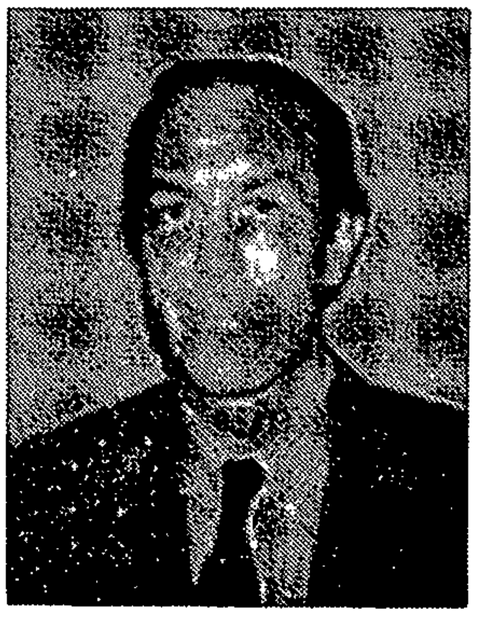

The Jersey Exempt Company

Keith A. Jenkins

Keith Jenkins is a Managing Partner of the Jersey Office of Peat Marwick, Channel Islands, a member firm of KPMG.

WHY A JERSEY COMPANY

Companies are incorporated in Jersey for a wide variety of reasons. Some are, of course, formed by residents of the Island, as trading vehicles, where the protection of limited liability is thought desirable. Others are formed as investment holding companies, by residents and non-residents alike, to hold property or other assets situated in the United Kingdom or elsewhere, where, for example, the beneficial owner is not domiciled in the United Kingdom and wishes to protect such assets from U.K. inheritance tax. Where laws permit, some are formed as trading companies to shelter profits derived from a foreign trade, from oppressive taxation or restrictive legislation in the country of residence of the beneficial owner. Some companies are owned by individuals, some by other companies, and many by trusts established for that purpose in the Channel Islands.

BACKGROUND – THE CORPORATION TAX COMPANY

Prior to 31 December 1988, all such companies, if regarded as being resident in Jersey, were liable to Jersey income tax at 20% on their world-wide income, or, if not so resident, to a flat rate corporation tax charge of £ 500 per annum. Such companies were known as Corporation Tax Companies. The location of board meetings and the residence status of directors were critical factors in determining management and control for residence purposes. It was therefore common practice for companies incorporated and administered in Jersey to have a board consisting of 2 non-resident directors and one resident director, the latter for administration purposes, whose board meetings took place in Sark which has no local taxation.

In practice, it was generally accepted by the Jersey income tax authorities that these Corporation Tax Companies were indeed managed and controlled from Sark. That view, however, was not always so readily accepted by the U.K. Inland Revenue. In general, although no specific legislative provision debarred Jersey residents from owning Corporation Tax Companies, in practice this would normally have given rise to a claim from the Comptroller of income tax that the beneficial owner exercised control from Jersey. In a similar way, companies incorporated outside of Jersey were liable to Jersey income tax if managed and controlled from Jersey.

The beneficial ownership of a Corporation Tax Company was required to be disclosed to the Commercial Relations Officer in Jersey upon incorporation. Where the company was to be owned by a settlement, then details of the trustees and of the settlor were also required to be disclosed. In theory, there was a requirement that details of beneficiaries should be disclosed, but in practice this was seldom requested.

A Corporation Tax Company could readily change its status to that of an income tax company simply by moving its place of management and control to the Island. It was, however, very difficult indeed to effect a change in the other direction. Moreover, if a Jersey resident liquidator was appointed upon liquidation of a Corporation Tax Company, then he was liable to Jersey income tax on world income as it arose. To avoid a charge to income tax, it was therefore necessary to ensure the appointment of a non-resident liquidator, or the disposal of income-producing assets prior to the date of liquidation.

PRESENT LEGISLATION – THE EXEMPT COMPANY

On 6 December 1988, after considerable local pressure from the finance sector in Jersey and after consultations between interested parties, the Assembly of the States of Jersey passed legislation under which the Corporation Tax Company was abolished and the concept of an exempt company introduced. This legislation, contained in an amendment to Art. 123 of the Income Tax (Jersey) Law 1961, became effective from 1 January 1989; after that date all companies incorporated in Jersey are resident in Jersey for income tax purposes and are liable to Jersey income tax at 20% on world profits, unless they elect for exempt company status. An exempt company is defined as one which:

(a) has made the required election and has paid the annual fixed tax charge of £ 500 within the requisite time period; and
(b) is either:
  (i) a collective investment fund; or
  (ii) in the beneficial ownership of non-Jersey residents throughout the year ending 31 December and has confirmed that the required disclosures have been made to the Commercial Relations Officer.

The place of management and control of companies incorporated in Jersey therefore ceases to be of relevance. It will, however, continue to be of importance to companies incorporated outside of Jersey, although these companies may also take advantage of the

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exempt company procedure if they so wish. The same election, payment and disclosure requirements apply to a company incorporated outside of Jersey as to one incorporated in Jersey if it wishes to be treated as exempt.

The election for exempt company status and the payment of the tax charge of £ 500 are required on an annual basis and will normally need to be made to the Comptroller of income tax by 31 March in each year of assessment.

Newly-incorporated companies and foreign companies becoming resident in Jersey are required to submit elections for exempt company status within 3 months of incorporation, or of becoming resident, as the case may be. The Comptroller of income tax, in his explanatory booklet, "Guide to the Exempt Company", issued in December 1988, has, however, advised that in order to ease the introduction of the legislation, transitional provisions with regard to time limits will be available for 1989 and 1990. Claims will be accepted, without further ado, up to 30 June 1989 and 1990, and sympathetic consideration will be given in 1989 only, to late applications up to 30 September 1989, where the companies concerned were Corporation Tax Companies for 1988.

The term "beneficial ownership" is very broadly defined, and is designed primarily to prevent Jersey residents using exempt companies by indirect ownership. The disclosure requirements therefore include details of ownership, whether through trusts or indirect ownership through other companies, and in the case of companies owned by trusts, details of the residence of beneficiaries must also be disclosed. The only exception is where ownership is through a publicly listed company. In addition, the company is required to make an annual statement to the Comptroller of income tax that no changes have taken place in its beneficial ownership since this was last disclosed to the Commercial Relations Department, which department is responsible, inter alia, for Jersey company regulatory matters. The company is also required to advise the Commercial Relations Department of any changes in its beneficial ownership as they occur. If the company is owned by a trust, then that department has confirmed that it will normally be adequate to advise them of any changes of trustees, or if there should be any additional settlor of the trust.

It should be noted that disclosure of beneficial ownership is made to the Commercial Relations Department and not, in fact, to the Comptroller of income tax. In this way, it has been suggested that information not in the hands of the Comptroller of income tax will not be capable of being disclosed to the U.K. Inland Revenue under the terms of the United Kingdom–Jersey Double Taxation Agreement.

There are provisions whereby if the Commercial Relations Department is not satisfied that full disclosure of beneficial ownership has been made, then it has authority to notify the Comptroller accordingly, who can either refuse to grant exempt status for that year or to withdraw exempt status if it has already been granted. In the case of a company which was previously a Corporation Tax Company, then the full disclosure requirements as detailed above will not be required for 1989 and 1990 as a transitional provision. It should be noted that exempt company elections will be refused for companies which are in arrears with their corporation tax or income tax affairs, and that the exempt company fee is payable in full in the year of incorporation as well as in the year of liquidation.

The level of disclosure of information required is seen by the authorities in Jersey as being an important tool in discouraging certain types of non-resident ownership of Jersey companies, and has helped Jersey to avoid the type of unfortunate publicity endured by other offshore centres in recent years. It is thought that the stringent updating requirements on beneficial ownership will further strengthen this position. As the place of management will no longer be of importance in deciding central management and control, then obviously the location of board meetings and the residence of executive directors will equally be of no importance. It is hoped that this will encourage the appointment of Jersey-based directors to the boards of exempt companies, and that this will further reinforce the good management of these companies.

COLLECTIVE INVESTMENT FUNDS

Collective investment funds, as defined in Jersey legislation, will now be able to apply for exempt company status. This is allowed regardless of the residence status of individual shareholders and such companies will now be able to market their products on the Island. However, conditions attached to the granting of exempt status to such offshore funds will include the requirement to deduct Jersey income tax from dividends paid to Jersey residents, and to make known to the Comptroller of income tax, when required to do so, the names and addresses of Jersey resident shareholders. In addition, roll-up type funds are required to give due prominence in their prospectuses to a statement reminding prospective Jersey investors that they might face liability under Jersey anti-avoidance legislation.

TAXATION OF EXEMPT COMPANIES

Unless an election is made for exempt company status, a company incorporated in Jersey will be deemed to be resident here and liable to income tax on its worldwide profits. An exempt company may change its status by becoming an income tax company at any time. However, an existing income tax company, if it has already been an exempt company, may not become an exempt company again unless it has changed its beneficial ownership or if, for example, the beneficial owner previously resident in Jersey emigrates from the Island.

By definition, the exempt company will not be liable

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to Jersey tax on foreign income, nor, by concession, on bank interest arising in Jersey. It will, however, have an income tax liability in addition to the annual charge of £ 500 on any other Jersey-source income, including trading income. It is, as usual, difficult to define "trading". However, it should be noted that exempt companies will not be liable to tax on trading profits unless the trade is carried on in Jersey through "an established place of business". The conduct of administrative functions, the execution of contracts and the holding of board meetings within Jersey will not of themselves be sufficient to establish a place of business in Jersey.

It is possible in Jersey to obtain advance rulings from the Comptroller of income tax's department in connection with income tax aspects of proposed activities and the author has always found the staff of the Comptroller's department helpful and courteous in this respect. It should, however, be emphasized that the concepts of "trading" and "established place of business" are difficult to define and have inherent problems and it is therefore recommended that professional assistance should be obtained in every case.

A newly-inserted article, Art. 123A of the Income Tax Law, specifically provides that a Jersey exempt company will not be regarded as being resident in Jersey for the purposes of the United Kingdom–Jersey Double Taxation Agreement. Dividends and interest paid by an exempt company will not therefore be regarded as Jersey-source income. Remuneration paid by a Jersey exempt company to non-resident directors will also not be regarded as Jersey-source income and will not be liable for income tax in Jersey. Where such companies are owned by U.K. resident companies, then the U.K. Inland Revenue's legislation relative to controlled foreign companies will be applicable.

Whether or not it will be easier to convince the U.K. Inland Revenue that companies are indeed controlled by a board of directors based in Jersey where board meetings are actually held in Jersey, rather than by having a number of Sark directors and board meetings held in Sark, remains to be seen. I am sure it is not necessary to emphasize further at this point that whenever offshore companies are used in any U.K. tax planning exercise, it must always be self-evident that control is exercised outside of the United Kingdom and that this can be so demonstrated.

The reader will of course be aware that legislation enacted in the United Kingdom will now enable the U.K. Inland Revenue to tax as resident in the United Kingdom any company incorporated there regardless of its place of management and control. It might therefore be worthwhile considering whether such companies should be liquidated and re-formed as Jersey exempt companies. It should be noted in this respect that in the past a Jersey resident liquidator of a Corporation Tax Company has had a liability to Jersey income tax on all sources of income. In future, however, liquidators of companies which are in the beneficial ownership of non-Jersey residents will not be liable to Jersey income tax other than on Jersey-source income, with the exception, by concession, of Jersey bank interest. Any U.K. registered non-resident companies which need to be liquidated following the change in U.K. legislation could therefore be liquidated in Jersey.

CONCLUSION

In conclusion, it is felt that the new legislation introduced to bring the Jersey exempt company into existence is important in that it is a radical change in the system operated hitherto. Until recently, Jersey did not regard itself as being a tax haven, but insisted on its position as a low tax area and offshore finance centre. The introduction of the exempt company legislation might be seen as being the first step in establishing Jersey as an international tax haven. It also has the desirable effect of eliminating the need for much of the time consuming and administratively inconvenient requirements of the former regime, in that it will no longer be necessary for documents to be sent off the Island for signature, nor will it be necessary for foreign directors to find their way to Sark or other non-Jersey locations for board meetings.

The exempt company replaces the Corporation Tax Company and continues to be useful for many of the purposes for which the Corporation Tax Company was used. One of the most common uses was, as has already been indicated, for the sheltering of assets situated in the United Kingdom and elsewhere from potential tax liabilities in those countries. A typical structure in this respect might be a Jersey exempt company owning property in the United Kingdom, which is itself owned by a Jersey discretionary trust where the settlor was not domiciled in the United Kingdom at the date on which the settlement was established.

The reader will be aware that the questions of residence and domicile in the United Kingdom have been receiving attention for some time now, and indeed it was thought that some changes would be effected in the United Kingdom 1989 Budget, but this does not appear to have actually happened. It may be, however, that such changes will not be much further delayed and any action necessary to shelter such individuals should be taken sooner rather than later. It is suggested that the Jersey exempt company might play a useful part in any such planning.

Broadly speaking, the Corporation Tax Company along very similar lines to those which had applied in Jersey continues in the neighbour Channel Island of Guernsey until at least 1989. It is understood that legislation similar to that introduced in Jersey is pending in Guernsey, which is expected to become effective from 1 January 1990.

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BULGARIA:

Favourable Climate for Foreign Investment

Sophia Press Agency

Bulgaria's participation in international economic affairs is of vital importance for the development of its national economy. This is evident from the total value of its exports which are a little over 50% of the national income. In 1988, the foreign trade commodity exchange amounted to U.S.$ 33,800 million, a considerable amount for a country of 9 million.

Consequently, the problems concerning Bulgarian foreign trade and promotion of the national producers' participation in the international division of labour occupy a prominent place in the State economic policy and the reform which has been carried out since 1987. The aim of this reform is to stimulate economic initiatives, combine market mechanisms with the State strategy in politics, the economy and the social sphere through self-management of enterprises, financial and foreign currency self-support. Implementation of the reform involves opening the national economy to the foreign market as well as expansion and diversification of economic, industrial and technological cooperation with foreign partners.

Bulgaria was among the first of the socialist countries to adopt special regulations on joint ventures with foreign investment participation. The State Council's Decree 535 of 1980 concerning economic cooperation between Bulgarian legal persons and foreign legal or physical persons was universally acknowledged as a flexible and democratic system of setting up joint ventures and one which gives broad freedom to the participants and does not limit the share of foreign participation. However, Bulgaria did not engage in extensive business relations with western countries. In 1988, there were only 20 companies with western partners and only about 220 contracts for industrial cooperation were signed as a result of the Bulgarian economy, bureaucratic procedures in decision making and insufficient economic interest of Bulgarian organizations. This state of affairs is confirmed by the fact that nearly half of the joint ventures were set up in 1988 when the economic reform grew apace and enterprises were granted more freedom.

In the beginning of 1989, the reform entered a new phase. With the State Council's Decree 56 of 9 January and the rules for its application subsequently adopted by the Council of Ministers, radical changes were made in the economic structure, the conditions for economic activity and investment cooperation with foreign companies. The Decree removes the bureaucratic administrative structures in the economy, eliminates the State monopoly of foreign trade, checks monopolies and promotes competition. On the whole, Decree 56 offers ample opportunity for economic initiative and enterprise and creates conditions for cooperation with foreign partners. Another significant feature of the Decree is that it sets in motion the process of bringing Bulgarian legislation into line with the economic and trade legislation of its major partners.

This article deals with the points concerning foreign investment in Bulgaria and the business conditions for foreign persons and companies.

COMPANY FORMATION

A distinctive feature of Decree 56 is the introduction of company formation. Companies are established as the basic units of the national economy, i.e. independent self-managing firms which have economic capacities and legal guarantees for initiatives and progress. Under the Decree, companies can be State cooperative companies of public organizations, partnerships or individual firms. The choice of whether to establish a State cooperative, shareholding or other company depends solely on the economic interests of the participants. All companies are guaranteed equal conditions for economic activity.

All companies, except for individual and collective companies, are legal persons which are registered at the district court. Companies draw up their own plans and obtain funding in levs and in foreign currency. In general, a company must carry out the purpose for which it was established but it may also engage in any other business activity not prohibited by law. A company may issue bonds and employee shares. The company's independence is evident in its management which includes a board of management, board of comptrollers and a manager. State and municipal companies also have a general meeting of the employees while shareholding companies with limited liability have a meeting of the shareholders (the partners).

Under the new conditions, the State will govern the economy via a system of economic regulations, without directly interfering in the company's activity, i.e. through a system of taxation, price formation, currency regulations, interest rates, depreciation and Government contracts.

BROAD ACCESS TO FOREIGN MARKETS

The new rules for company formation reflect radical changes in the conditions for foreign business activities. Decree 56 eliminates the foreign trade monopoly. A company which is a legal person is free to conduct business abroad, including the foundation of and participation in joint companies and other investments; no permission from a State entity is required. The company can engage in these activities on its own, through a company with which it is a partner or through a third company. The Council of Ministers,

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however, has authority to set import and export conditions and quotas and introduce a permit regime for certain foreign transactions. The company must register each transaction with the Ministry of Foreign Economic Relations within 7 days. Participation in companies outside Bulgaria as well as other investments abroad are also subject to registration. An individual firm may not export goods manufactured by other companies, import goods other than for its own purposes, make investments abroad or enter into partnerships with foreign persons in Bulgaria or abroad.

A company shall obtain foreign currency from exports, credits from Bulgarian or foreign banks and the purchase of foreign currency from the State or at foreign currency auctions. From the currency fund, a company can purchase raw and primary materials, machinery and technologies or use the funds for support representations abroad, advertising and transport fees. Foreign currency expenditures not related to the company's economic activity are disallowed.

FAVOURABLE CONDITIONS FOR FOREIGN INVESTMENTS

Giving Bulgarian companies ample access to foreign markets, Decree 56 offers better opportunities for the investment of foreign capital in Bulgaria, the setting up of joint ventures and application of all modern forms of joint cooperation. Compared with the preceding Decree 535, which was repealed in the beginning of 1989, the new rules offer much better conditions for the business activity of foreign persons, which can be summarized as follows:

- better matching of the interests of the foreign partners and Bulgarian companies;
- property guarantees for foreign investors;
- favourable profit transfer, taxation, employment and foreign trade;
- priority for investments in high technology sectors as well as investments which support the domestic market by exporting of some of the products;
- simplified procedures for setting up and operating joint ventures.

The State protects the business activity and investments of foreign persons and provides equal economic and legal conditions to all participants. In principle, foreign investments are not subject to administration or seizure but if important State or public needs (which cannot be fulfilled in any other way) necessitate expropriation of foreign investments or immovable property, these are paid by agreement.

A foreign person can do business in Bulgaria independently or through a partnership. For an independent agreement, the foreigner must obtain permission from the Ministry of Foreign Economic Relations. Similar permission is required when a foreign company decides to set up a subsidiary.[1] Only the activities specified in the permit may be carried out. A bank subsidiary must have a minimum statutory fund of 10 million levs.

With the permission of the competent State body, a foreign person can open a trade representation which is not a legal person. An important prerequisite, however, is that at least one half of the representation employees are Bulgarian nationals.

A foreign person is entitled to found or acquire shares in limited liability companies as well as purchase nominal shares and set up shareholding companies. No permission from the State body is required if the foreign participation in a limited liability company is less than 49% (and less than 20% in a shareholding company).

With a view to stimulating long-term and larger investments in partnerships and subsidiaries, Chapter 5, Sec. II of Decree 56 (and the rules for its application) provides special conditions for the activities of shareholding and limited liability companies where the foreign participation is more than 49% and exceeds 5 million levs in foreign currency or 50 million transferable roubles. The same conditions apply to a partnership with a smaller foreign participation which has been allowed by a competent State entity to operate under the provisions of Sec. II. In all cases, the Decree's general company rules apply.

Decree 56 introduces substantial changes in the taxation of the business activity of foreign persons. Subsidiaries, legal persons, shareholding and limited liability companies operating under Chapter 5, Sec. II are taxed at 30% of their profit. If a foreign company carries out independent activities without setting up a legal entity in Bulgaria, the profit tax is 40%. In both cases, the profit tax is lower than for Bulgarian companies. All other shareholding and limited liability companies with foreign participation are treated as Bulgarian companies.

Decree 56 introduces a new tax for foreign persons, i.e. a 15% tax on the revenues from dividends, interest, royalties, licenses, technical service fees and rents. Partnerships with foreign participation under Chapter 5, Sec. II which receive dividends from shares and profits from share capital are taxed at 10% of the gross amount of the dividends.

The new tax system for foreign persons provides a number of reliefs:

- profits of shareholding and limited liability companies with foreign participation over 49% and exceeding 5 million levs in foreign currency or 50 million transferable roubles are exempt from tax for a period of 5 years after registration if their activity is in high technology sectors specified by the Council of Ministers;
- these shareholding and limited liability companies can deduct losses from their profit over the subsequent 5 years;

1. The foreign company must be a legal person registered with the district court.

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- tax exemption for licence revenues for transferring industrial properties in priority sectors specified on the list of the Council of Ministers;
- tax exemption for, inter alia, dividends if used for purchasing shares and bonds in Bulgaria.

The new rules for economic activity in Bulgaria by foreign persons also regulate the acquisition of immovable property and property rights. In principle, partnerships with foreign participation and foreign persons' subsidiaries cannot become owners of land, mineral resources, forests or waters. With permission of the Council of Ministers, however, they can acquire construction rights and leases on immovable property for a specified period of time in order to carry out their economic activities. The price of the immovable property or property rights will be agreed upon by the parties.

Since 1988, Bulgaria has granted an opportunity to foreign companies and persons to carry out business activities in duty-free zones. The first zones were at the Danube ports of Vidin and Rousse. These zones provide favourable conditions for a wide range of activities. Profits derived from activities in duty-free zones are tax-free for the first 5 years and then are taxed at 20%.

It is too early to assess the results of Decree 56; however, 2 joint ventures have already been concluded with French and Scottish partners.

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Abbreviations, terms and references to laws in force

Bibliography

Also: discussion of international regulations concerning tax law in the CMEA (by Prof. T. Nagy)

Countries covered:

Bulgaria	(Dr. N.W. Watschev)	Poland	(Prof. Dr. M. Weralski)
Czechoslovakia	(Dr. M. Bakeš)	Romania	(Dr. I. Condor)
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IFA NEWS

BRITISH BRANCH

CHANGES OF OFFICERS

Mr. David Davidson, our Chairman, and Mr. John Phillips, our Honorary Treasurer, have both indicated that they intend to retire as officers of the British Branch at the 1989 Annual General Meeting. At a Committee Meeting on 20 March 1989 the Committee elected Mr. John Avery Jones, Partner in Speechly Bircham, to be the new Chairman and Mr. John Fairley, Partner in Ernst and Whinney, to be the new Honorary Treasurer effective from the 1989 AGM. Mr. Noel Davison of Ernst and Whinney was elected as Honorary Assistant Treasurer.

It was proposed that Ms. Yuri Tabuchi of Touche Ross will replace Ms. Claire Beziau of Touche Ross as the Honorary Assistant Secretary.

COMMITTEE

Following discussions with the Inland Revenue about greater participation by the Inland Revenue in Branch activities, at its meeting on 20 March 1989 the Committee co-opted as a member of the Committee Mr. B.T. Houghton, Commissioner of Inland Revenue and Director of the International Policy Division at the Inland Revenue. Mr. John Fairley was also co-opted as a member of the Committee to serve until the 1989 Annual General Meeting.

Messrs. D.F.A. Davidson, J.S. Phillips, G.D. Swaine and D.G. Tapper retired from the Committee at the 1989 Annual General Meeting by rotation and offered themselves for re-election. Mr. D.A. Clarke and Mr. H.L. Duncan also retired from the Committee by rotation and were not offering themselves for re-election.

Nominations have been received for the election to the Committee of:

David F.A. Davidson – Arthur Andersen & Co.
John Fairley – Messrs. Ernst & Whinney
John S. Phillips – Price Waterhouse
G. David Swaine – Shell International Petroleum Ltd.
Denis G. Tapper – Chiltern Financial Services Ltd.

BRANCH ACTIVITIES

Any ideas/suggestions/criticisms on topics for discussion, volunteers as speakers, recommendations/introductions to suitable speakers or on the running of the branch and its programme will be gratefully received.

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JOINT SEMINAR OF THE U.S. AND BRITISH BRANCHES – 7 & 8 SEPTEMBER 1989

Immediately prior to the 1989 Congress in Rio de Janeiro the U.S. and British Branches will be holding a joint seminar on current topics of interest in U.S. and U.K. taxation on 7 & 8 September 1989 at the Biltmore Hotel in Miami, Florida, U.S.A. Arrangements for the seminar are currently being finalized and it is hoped that full details together with application forms will be circulated shortly.

REPORT BY THE CHAIRMAN TO THE MEMBERS FOR THE YEAR TO 31 MARCH 1989

Membership

The current number of members is 551 being 386 individual members, 155 corporate members and 10 overseas members. This compares with a total membership of 531 at the time of the 1988 AGM, i.e. an overall increase of 20.

Meetings

Ten technical meetings were held during the year which were generally well attended. One meeting dealt with a particular overseas country (Japan) and another was on European Tax Harmonization. The other eight meetings were on international aspects of U.K. taxation and general international taxation. One of our meetings was followed by an informal supper. There was also a wine tasting, but very sadly this was the last wine tasting presented by Mr. Anthony Goldthorpe as he died suddenly a few weeks after the meeting.

Manchester sub-branch

During the year a programme of six meetings was held by the Manchester sub-branch.

Annual Dinner

The 1988 Annual Dinner was held on Friday 20 May 1988 at the Inner Temple. The Guest of Honour was The Right Honourable Lord Goff of Chieveley PC, a Lord of Appeal in Ordinary. The 1989 Annual Dinner is to be held on Friday 9 June 1989 at the Middle Temple. The Guest of Honour is to be Mr. J.B. Unwin, Chairman of Customs and Excise.

Joint seminar with the Canadian Branch

A joint seminar was held with the Canadian Branch in London on 9 and 10 September 1988 and was attended by 110 members of the two branches.

Officers

As I hand over the Chairmanship to John Avery Jones, I would like to express my thanks to our Honorary Secretary, Honorary Treasurer, their assistants and all Committee Members for the work they have put in and for making my tenure as Chairman most enjoyable.

Bibliography

Books

The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 50-52 of the January 1989 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

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(B. 108.992)

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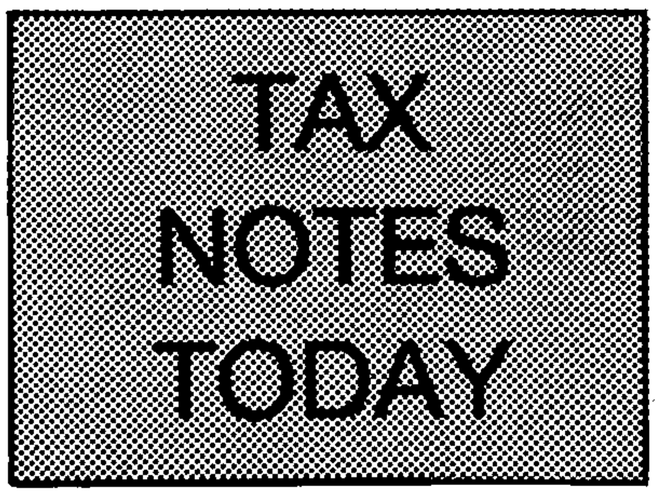

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BRAZIL: GUIDE TO TAXATION, TRADE AND INVESTMENT 355

As a preface to the special IFA issue of the Bulletin, *this article highlights the most salient aspects of doing business in Brazil, i.e. forms of Brazilian business organizations, investment and foreign exchange controls, labor regulations, and taxation of business enterprises and individuals.*

Mailson F. da Nóbrega:

TAX POLICY IN BRAZIL 364

The Brazilian Minister of Finance offers an explanation of how tax policy is formulated in Brazil. Included is an overview of previous tax systems, their deficiencies and how the deficiencies were corrected. He concludes with a discussion of the recent amendments effected by the 1988 Constitution and the fiscal outlook for Brazil.

Agostinho Toffoli Tavolaro:
BRAZIL: TAXATION AGREEMENTS UNDER THE NEW CONSTITUTION 371

Since Brazil is a Federative Republic, the Federal Government possesses sovereignty, whereas the States, the Municipalities and the Federal District possess only autonomy. As a result only the Federal Government may enter into a double taxation agreement. However, the Federal Government must conform to various constitutional principles concerning the autonomy of the other levels of government. Certain problems are likely to arise in this context and this article examines several of these problems.

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Luiz Fernando Teixeira Pinto:

BRAZILIAN TAX TREATMENT OF FOREIGN INVESTMENTS 376

This article examines the legislative framework and attending regulations regarding investments made in Brazil by an individual or company domiciled abroad.

Gilberto de Ulhoa Canto:

BRAZIL: THE CONSTITUTIONAL TAX REFORM 1988: AN OVERVIEW 379

This article overviews the taxation aspects of Brazilian Constitutions – both old and new. The author concludes that it is far too early to predict whether the new tax system instituted by the 1988 Constitution will meet the needs of the Union, the States and the Municipalities.

Francisco Dornelles:

BRAZIL: THE RELEVANCE OF DOUBLE TAXATION TREATIES FOR DEVELOPING COUNTRIES 383

The untoward effects of double taxation are more glaring when the movement of capital, money and technology takes place from and to developed and developing countries. Tax treaties between developed and developing nations play an important role in the foreign investment policy of capital importing countries. This article examines the various methods for the elimination of double taxation taking into account the special circumstances of developing countries.

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Prof. C.A. Longo:

BRAZIL: FISCAL ISSUES AND THE 1988 CONSTITUTION 389

Allocation of public expenditure and revenues among different levels of government depends not only on a country's cultural background and historical opportunities but also on the adoption of clearly centralized or decentralized fiscal policies. This article describes and analyzes the slicing of the "fiscal pie".

N. Latorraca and J.C. Barbuto:

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This article reviews various facets of the tax system established by the 1988 Constitution. Included in the discussion are definition of tax, authority to tax, limitations on the power to tax, allocation of jurisdiction and distribution of tax revenue.

Eivany Antonio da Silva:

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Ives Gandra da Silva Martins:

BRAZIL: INFLATION AND TAXATION 403

Mr. Gandra examines the various causes underlying Brazil's chronic and rampant inflation. Included in his discussion are methods of combating inflation (i.e. reducing expenses or increasing revenues) and the legal regulation of inflation through indexation.

Joseph C. Amico:

BRAZIL: DEVELOPING AND IMPLEMENTING TAX TREATY POLICY: THE TAX SPARING CLAUSE 408

This article examines how a developing country may formulate and implement its tax treaty policy, in particular by using tax sparing clauses. The author discusses the relevant concepts of tax treaties as well as various aspects of a developing country's formulation and implementation of tax treaty policy, i.e. policy concepts the country wishes to utilize, entering into bilateral negotiations with potential partners and administration of a treaty network.

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Arthur Andersen:

Brésil: Guide de l'imposition commerciale et des investissements . *355*
Cet article tenant fonction de préface au numéro spécial du *Bulletin* consacré au Congrès de l'IFA, fait ressortir les aspects les plus frappants des réglementations des activités commerciales au Brésil, à savoir: les formes d'organisations commerciales au Brésil, les investissements et les contrôles des changes, les réglementations du travail, l'imposition des entreprises commerciales et des personnes physiques.

Mailson F. da Nóbrega:

Politique fiscale au Brésil *364*
Le Ministre des Finances brésilien a expliqué comment est formulée la politique fiscale au Brésil. Il fait un résumé des systèmes fiscaux précédents de leurs défauts et de la façon dont on a essayé d'y remédier. Il conclut par un commentaire sur les amendements récents introduits par la Constitution de 1988 et les perspectives fiscales pour le Brésil.

Agostinho Toffoli Tavolaro:

Brésil: Conventions fiscales en application de la nouvelle constitution *371*
Le Brésil étant une République Fédérale, c'est le gouvernement fédéral qui détient la souveraineté alors que les états, les communes et le district fédéral ne possèdent que l'autonomie. Le gouvernement fédéral est seul autorisé à négocier des conventions de double imposition. Il doit néanmoins se conformer aux différents principes constitutionnels quant à l'autonomie des autres niveaux gouvernementaux. Ceci n'ira pas sans créer certains problèmes, et l'auteur en analyse ici quelques-uns.

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Luiz Fernando Teixeira Pinto:

Traitement fiscal brésilien des investissements étrangers *376*
L'auteur analyse le cadre législatif et les règlements qui en découlent dans le domaine des investissements réalisés au Brésil par des personnes physiques ou morales non-résidentes.

Gilberto de Ulhoa Canto:

Brésil: La réforme fiscale constitutionnelle de 1988: vue d'ensemble *379*
Cet article passe en revue les aspects fiscaux des constitutions brésiliennes – l'ancienne et la nouvelle. L'auteur considère qu'il est beaucoup trop tôt pour savoir si le nouveau système fiscal introduit par la Constitution de 1988 répondra aux besoins de l'Union, des Etats et des Communes.

Francisco Dornelles:

Brésil: L'opportunité des conventions de double imposition pour les pays en voie de développement *383*
Les effets malencontreux d'une double imposition sont plus manifestes lorsque les mouvements de capitaux, de devises et de technologie ont lieu entre pays développés et en voie de développement. Les conventions fiscales entre pays développés et en voie de développement jouent un rôle important dans la politique des investissements étrangers des pays importateurs de capitaux. Cet article analyse les différentes méthodes utilisées pour l'élimination d'une double imposition qui tiennent compte des circonstances particulières des pays en voie de développement.

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Richard M. Hammer:

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Arthur Andersen:

Brasilien: Leitfaden zur Besteuerung von Handel und Investitionen . *355*
Als Vorwort der Sonderausgabe des *Bulletin* betont dieser Artikel die meist hervortretenden Aspekte der Geschäftstätigkeit in Brasilien, d.h. Formen der brasilianischen Geschäftsorganisationen, Investitions- und Devisenkontrolle, Arbeitsregelungen, sowie die Besteuerung der Geschäftsunternehmen und einzelner Personen.

Mailson F. da Nóbrega:

Steuerpolitik in Brasilien *364*
Der brasilianische Finanzminister erläutert, wie die Steuerpolitik in Brasilien formuliert wird. Mit einbezogen ist eine Übersicht von vorherigen Steuersystemen, deren Mängel und der Korrektur dieser Mängel. Er schliesst mit einer Diskussion über die vor kurzem durch die Verfassung von 1988 bewirkten Änderungen und steuerlichen Aussichten für Brasilien.

Agostinho Toffoli Tavolaro:

Brasilien: Steuerabkommen nach der neuen Verfassung *371*
Da Brasilien einen Föderativstaat bildet, hat die föderale Regierung die Oberherrschaft, während die Staaten, die Gemeinden und der federale Bezirk nur autonom sind. Deswegen darf nur die föderale Regierung Doppelbesteuerungsabkommen abschliessen. Trotzdem muss verschiedenen verfassungsmässigen Grundsätzen bezüglich der Autonomie der anderen Verwaltungsebenen entsprechen.

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Luiz Fernando Teixeira Pinto:

Die brasilianische steuerliche Behandlung von Auslandsinvestitionen *376*
In diesem Artikel wird eine Untersuchung nach dem gesetzlichen Rahmen und begleitenden Regelungen bezüglich Auslandsinvestitionen in Brasilien durch eine nicht-ansässige Person oder Gesellschaft vorgenommen.

Gilberto de Ulhoa Canto:

Brasilien: Die verfassungsmässige Steuerreform 1988: Eine Übersicht *379*
Dieser Artikel bietet eine Übersicht über die steuerlichen Aspekte der alten sowie der neuen brasilianischen Verfassung. Es ist aber nach Meinung des Autors verfrüht, vorherzusagen, ob das von der Verfassung 1988 eingeführte neue Steuersystem den Bedürfnissen der Union, der Staaten und der Gemeinden entsprechen wird.

Francisco Dornelles:

Brasilien: Die Relevanz der Doppelbesteuerungsabkommen für Entwicklungsländer *383*
Die bedauerlichen Auswirkungen der Doppelbesteuerung scheinen um so greller, wenn die Bewegung von Kapital, Vermögen und Technologie zwischen entwickelten Ländern und Entwicklungsländern stattfindet. Doppelbesteuerungsabkommen zwischen entwickelten und Entwicklungsländern spielen eine wichtige Rolle in der Auslandsinvestitionspolitik Kapital-einführender Staaten. Dieser Artikel bietet eine Untersuchung der verschiedenen Methoden zur Vermeidung der Doppelbesteuerung unter Berücksichtigung der speziellen Verhältnisse der Entwicklungsländer.

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Prof. C.A. Longo:

Brésil: La fiscalité et la Constitution de 1988 ..... *389*
La répartition des dépenses et recettes publiques entre les différents niveaux gouvernementaux ne dépend pas seulement de la tradition culturelle d'un pays ni de raisons historiques mais aussi de l'adoption d'une politique fiscale nettement centralisée ou décentralisée. Cet article décrit et analyse le partage du "gâteau fiscal".

N. Latorraca et J.C. Barbuto:

Brésil: Le système fiscal national – la Constitution de 1988 ..... *394*
Cet article analyse un certain nombre des aspects du système fiscal établi par la Constitution de 1988, à savoir: la définition de l'impôt, l'autorité d'imposer et les limites qui y sont apportées, la compétence des juridictions et la répartition des revenus fiscaux.

Eivany Antonio da Silva:

Brésil: Le nouvel impôt sur le revenu appliqué et les conventions de double imposition *399*
Bien que la réforme de l'impôt sur le revenu des personnes physiques au Brésil contienne quelques points très spécifiques, elle suit dans son ensemble le même courant que des réformes semblables introduites dans d'autres pays. Cet article fait ressortir quelques aspects de la réforme de 1988 et commente ses effets sur les conventions fiscales signées par le Brésil. Il examine en conclusion le problème de savoir si la réforme fiscale aura un impact quelconque sur le développement des investissements au Brésil.

Ives Gandra da Silva Martins:

Brésil: Inflation et taxation *403*
M. Gandra examine les causes diverses qui sont à l'origine de l'inflation chronique et proliférante au Brésil. Il discute des méthodes pour combattre l'inflation (à savoir réduire les dépenses ou augmenter les revenus) et de la régulation légale de l'inflation au moyen de l'indexation.

Joseph C. Amico:

Brésil: Développement et application de la politique des conventions fiscales: la clause de crédit d'impôt fictif *408*
Cet article analyse comment un pays en voie de développement peut formuler et mettre en œuvre sa politique en matière de conventions fiscales, particulièrement par l'application des clauses de crédit d'impôt fictif. L'auteur donne un commentaire des concepts s'y rapportant dans les conventions fiscales ainsi que des différentes formulations utilisées par un pays en voie de développement et la mise en application de la politique d'une convention fiscale; à savoir les concepts qu'un pays souhaite utiliser dans ses négociations bilatérales avec des partenaires potentiels et l'administration d'un réseau conventionnel.

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Prof. C.A. Longo:

Brasilien: Steuerliche Fragen und die Verfassung von 1988 ..... *389*
Die Zuteilung der öffentlichen Ausgaben und Einnahmen auf unterschiedliche Ebenen der Verwaltung hängt nicht nur vom kulturellen Hintergrund und den historischen Möglichkeiten eines Landes ab, sondern wird auch durch die Annahme einer zentralisierten oder dezentralisierten steuerlichen Politik bedingt. Dieser Artikel beschreibt und analysiert das Aufschneiden des „steuerlichen Kuchens".

N. Latorraca und J.C. Barbuto:

Brasilien: Das nationale Steuersystem – Die Verfassung 1988 ..... *394*
Dieser Artikel bietet einen Überblick der verschiedenen Aspekte des von der Verfassung 1988 eingeführten Steuersystems unter Einschluss einer Definition der Steuer, Beschränkungen am Befugnis der Besteuerung, Zuteilung der Gerichtsbarkeit und Verteilung des Steueraufkommens.

Eivany Antonio da Silva:

Brasilien: Die neue Einkommensteuer und die Abkommen zur Vermeidung der Doppelbesteuerung *399*
Obgleich die brasilianische Reform der Einkommensteuer einige einzigartige Merkmale enthält, verfolgt die Reform im allgemeinen die Tendenz ähnlicher Reformen in anderen Staaten. Dieser Artikel hebt verschiedene Aspekte der Reform von 1988 hervor und diskutiert deren Wirkung auf die brasilianischen Doppelbesteuerungsabkommen. Der Artikel schliesst mit einer Betrachtung bezüglich der Frage nach den Auswirkungen der Steuerreform auf das Investitionsklima in Brasilien.

Ives Gandra da Silva Martins:

Brasilien: Inflation und Besteuerung *403*
Herr Gandra untersucht die verschiedene Ursachen der chronischen und wuchernden Inflation. In seine Beschreibung sind Methoden zur Inflationsbekämpfung (d.h. Ausgaben kürzen oder Einnahmen erhöhen) und die gesetzliche Regelung der Inflation durch Indexierung inbegriffen.

Joseph C. Amico:

Brasilien: Entwicklung und Durchführung einer Doppelbesteuerungsabkommenspolitik: Die fiktive Anrechnung nach der tax-sparing Klausel *408*
In diesem Artikel wird untersucht, wie ein Entwicklungsland seine Doppelbesteuerungsabkommenspolitik formulieren und durchführen könnte, insbesondere durch Anwendung von tax-sparing Klauseln. Der Autor diskutiert die entsprechenden Vorstellungen der Doppelbesteuerungsabkommen, so wie verschiedene Aspekte der Formulierung und Durchführung der Abkommenspolitik, das heisst, die politischen Vorstellungen, die das Land nutzen wünscht, wenn es Verhandlungen mit potentiellen Partnern eingeht und die Verwaltung eines Abkommensnetzes ausarbeitet.

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IFA 1989 Congress in Rio de Janeiro

Richard M. Hammer

Mr. Hammer is a partner with Price Waterhouse and is the National Director of International Tax Services based in New York. He is also the Chairman of Price Waterhouse World Firm International Tax Services Panel. He is a graduate of Princeton University and the Harvard Graduate School of Business. He is a member of the American and New York Institutes of CPA's. Currently, he serves as President of the International Fiscal Association and Vice Chairman of the Fiscal Committee of the Business and Industry Advisory Committee to OECD. Mr. Hammer is a frequent lecturer and has authored many articles on the subject of taxation.

The selection of Rio de Janeiro for the 1989 IFA Congress indicates more than a taste for famous beaches, breathtaking beauty, lively entertainment and fine food – although these factors were important.

The selection of Rio also reflects the globalization of IFA. Never before has the Congress been in South America twice in 6 years or in the Americas 3 times in the same span. I refer of course to the 1984 Congress in Buenos Aires and the 1986 Congress in New York. The membership is spreading around the world and, as a result, more branches are achieving the critical mass that makes outstanding local technical sessions possible.

But perhaps the most significant global development is Regional Conferences. I was fortunate to attend the first, held in New Delhi, in February 1988. More than 350 participants attended this meeting. The second Regional Conference will be held in Hong Kong in November 1989.

The annual Congress is our crown jewel and our main event, but unfortunately not everyone is able to attend every Congress. True globalization means that more of our members can gain significant benefit every year from belonging to IFA – and not just when the annual Congress is nearby.

In the 5 years since Buenos Aires, IFA membership has increased a solid 20%. Membership in Brazil is up 56%, in India it is up 66%, and in Hong Kong 49%. Western Europe, with well over half the membership, still is ahead in total numbers, but South America, the Pacific Rim and India are becoming major players.

Before leaving the statistics area, I should note that, while Western Europe's increase during this period was only 21% because of the high numbers they started with, they accounted for 59% (712 out of 1,208) of the membership increase.

The social side of the Rio Congress should be delightful, including some imaginative tours and the Gala Dinner at the Yacht Club of Rio de Janeiro. I mentioned breathtaking beauty. Surely no major city can be viewed to such advantage from a natural setting as Rio from the Sugar Loaf or from the magnificent mountain top site of the statue of Christ the Redeemer. Sugar Loaf is on the accompanying person agenda for Monday, and I hope that as many of the participants as possible also are able to squeeze in a view of Rio from the "air".

The Yacht Club venue will be a reminder of the wonderful reception and Dutch Dinner that the IBFD hosted a year ago at the Maritime Museum in the harbor at Amsterdam. If you were there, you will recall that we were transported by canal boats that picked us up at our hotels – they didn't do that even in Venice.

This is my last IFA Congress as your president. I am proud that the technical program is so strong. Both Subject I and Subject II are important and timely.

Subject I, "The disregard of a legal entity for tax purposes", is fundamental in several areas of cross-border taxation. These include (1) tax haven legislation (e.g. Subpart F), (2) anti-treaty shopping rules that the United States and others have invoked (the United States has done it unilaterally in some instances), and (3) the unitary method of taxing MNCs, which is associated primarily with California, but which has been considered by National Governments as a way to overcome transfer pricing manipulation. The United States, in fact, is starting down this path with its "super royalty" approach to adjusting the transfer price of intangibles.

Subject II, "Administrative and compliance costs of taxation", also is fundamental. Something is wrong when a medium-sized U.S.-based MNC *cannot* do its tax return without very sophisticated computer software.

In a nutshell, the United States' tax policy is that no complexity and no expense is unjustified if it prevents tax avoidance (as defined by our Revenue Service). The latest escalation of this concept is our PFIC rules, which tax U.S. shareholders on the unremitted earnings of portfolio investments in certain foreign corporations. The compliance burden on the corporations is such that some foreign corporations are eliminating U.S. shareholders. There can, in fact, be substantial compliance costs in merely determining if the rules apply to you. The concept, unfortunately, also was proposed recently in Australia.

I hope that the Subject II Resolutions Committee makes the most of its opportunity to speak out against this trend, as they speak from a forum that will attract some attention.

Welcome to Rio!

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Bay of Rio

Subjects and Seminars of the 1989 IFA Congress

Subject I
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BRAZIL:

Guide to Taxation, Trade and Investment

Arthur Andersen

This article was prepared by the Tax Division of Arthur Andersen in Brazil. In view of the constant changes in Brazil's economy in the last few months, it is suggested that no business decisions based on the article should be taken before contacting one of Arthur Andersen's offices in Brazil.

THE COUNTRY

The Federal Republic of Brazil has a population in excess of 140 million people. It has a land area of 8 million square kilometers, which is about the same size as the United States, and borders all the South American countries except for Chile and Ecuador.

The major Brazilian cities are the following:

Name of city	State	Population (1988)
São Paulo	São Paulo	10.8 million
Rio de Janeiro	Rio de Janeiro	6.0 million
Belo Horizonte	Minas Gerais	2.2 million
Salvador	Bahia	1.9 million
Brasília	Federal District	1.7 million
Fortaleza	Ceará	1.7 million
Curitiba	Paraná	1.4 million
Recife	Pernambuco	1.4 million
Porto Alegre	Rio Grande do Sul	1.3 million
Belém	Pará	1.2 million

GOVERNMENT AND 1988 CONSTITUTION

Brazil has a central Federal Government which has been located in Brasília, the country's capital, since 1960. The Government is divided into 3 branches, the executive, legislative and judicial, which are intended to achieve an appropriate balance of power. The country comprises 23 States which have a governor in addition to separate legislative and judicial branches.

The states and municipalities already have their own tax revenues and as a result of recent changes in the Constitution will also receive a part of Federal tax revenues. This decentralization should ultimately improve the efficiency of public spending.

A new Constitution came into effect in October 1988 and some of the principal changes introduced are summarized below:

- Several improvements in the area of civil rights such as severe restrictions on any form of censorship, strengthening of property rights, practically no restrictions on workers' strikes, improvement in measures to ensure ecological preservation, and the requirement that crimes involving terrorism and torture amongst others are not eligible for any form of amnesty or bail.
- Improvements in employee compensation and better protection of pensions paid by the National Social Security Institute from the effects of inflation.
- Decentralization of Government spending through redistribution of a part of Federal tax revenues to the state and municipal governments.
- Limit on interest rates of 12% per annum over and above inflation. This provision will require regulatory definitions.
- Definition of what constitutes a Brazilian enterprise with national capital.
- All mineral resources are the property of the Union (the country). Exploration of mineral resources may only be performed by Brazilian citizens or Brazilian companies with national capital.
- Protection of national companies through the concession of benefits and with the possibility of implementation of market reserve systems.

ECONOMY

The Brazilian economy expanded rapidly during the period 1968 to 1980 and the Gross National Product (GNP) increased an average of 7% per annum. In the last 7 years the GNP has fluctuated considerably as summarized below:

1981 to 1983 – Average decline per annum	−1.3%
1984 to 1986 – Average increase per annum	+6.8%
1987 – Increase	+2.9%

On 28 February 1986, a program was introduced to put a stop to inflation through a balanced Federal Budget and a price freeze that also affected salaries and wages. The cruzado (Cz$) became the new monetary unit equivalent to one thousand cruzeiros. The program was well received by the Brazilian people, at all levels, and brought back a degree of optimism to a nation of people that are traditionally optimistic.

After a few months of price stability, demand for all consumer goods increased rapidly, shortages developed and prices resumed a continuous upward trend that resulted in 62% inflation in 1986, 366% in 1987 and 300% in the first 8 months of 1988.

It is now clear to the Brazilian population in general that the high levels of inflation are mostly caused by deficit spending principally by the Federal Government and this understanding of the causes of inflation

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may be an important step towards eventually mitigating the problem.

Indexation (referred to as monetary correction in Brazil) was discontinued on 28 February 1986, as part of the price stabilization program, but was again resumed in November 1986 due to the resurgence of inflation after the short period of price stability. With inflation at the level of 20% per month in the third quarter of 1988 there is a widespread fear of hyperinflation in the near future that could virtually destroy the country's monetary system based on the cruzado and result in the informal adoption of some other value reference unit for internal pricing.

In spite of present uncertainties, Brazil has a well balanced economy in terms of a virtual self-sufficiency in agriculture and industrial production, diversified markets and inexpensive labor.

In the last 8 years substantial success has been obtained in the promotion of exports and the development of an energy program that has reduced the dependency on imports:

- As the result of a concerted effort to promote exports, the trade surplus in the 5 years to 1987 averaged 10.3 billion dollars per annum and is expected to exceed 17 billion dollars in 1988.
- The country's energy program has been successful through the development of alternate sources of energy, increase in hydroelectric production and increase in the domestic production of oil to over 50% of present consumption.

The program to produce alcohol from sugar cane has been so successful that over 90% of all automobiles produced in 1987, for domestic use, were powered by alcohol, but this has turned out to be a mixed blessing. With the substantial decline in worldwide petroleum prices the Federal program to promote the production of alcohol (Proálcool) will have to be reexamined and redirected to take into account that in terms of cost of production alcohol is not competitive with gasoline. The solution to this problem is not simple if one considers the very large number of people employed in the alcohol program.

The installed capacity of heavy and basic industries (heavy industrial machinery and equipment, shipbuilding, road building equipment, railway equipment, equipment for hydroelectric plants, offshore drilling equipment, steel, cement, aluminium, pulp, paper, etc.) is significant and provides the infrastructure to manufacture the capital goods necessary to increase the country's productive capacity or to earn additional foreign exchange from exports.

Capital investments have been waning in the last 2 years in the light of a general climate of uncertainty caused by increasing inflation as well as other internal factors. Although the perception of what might happen is probably worse than what will happen, a climate of reasonable optimism is necessary for a resumption of economic growth and prosperity.

BASIC INFRASTRUCTURE

Through a vast system of Government controlled industries, in the past 25 years the country has developed substantial hydroelectric capacity, a good postal service, an efficient telecommunications network, increased sanitation, water supply and increased production of crude oil. However, there is considerable concern as to whether there will be sufficient capital available in the public sector to ensure the expansion needed to cope with the demands of future economic growth. On the other hand, this could be the incentive needed to speed up the privatization of some of the economic activities conducted by the public sector.

MINING

Brazil has vast mineral resources, principally bauxite, iron ore, nickel, manganese, tin, copper, silver and gold. The production of aluminum in Brazil is a particularly attractive prospect because of the availability of bauxite and ample water supply for hydroelectric power projects. At Carajás, the country's most important mining area, a gigantic infrastructure is being installed for the economic development of iron ore and other natural resources; this area is expected to become one of the largest and most important mining developments in the world. However, the severe restrictions included in the 1988 Constitution regarding mining activities by multinational companies could result in a significant shortage of the capital resources needed to proceed with a dynamic program of research and development in the mining sector.

AGRICULTURE

Agriculture is an area with great potential. In addition to having large areas of undeveloped land, agricultural productivity in Brazil is relatively low and will undoubtedly improve dramatically over the next several years. The successful development, over a very short period of time, of a massive agricultural and industrial program to produce alcohol as a substitute for gasoline is testimony to the country's ability to respond quickly to economic challenges.

Brazil is leading producer of coffee, cocoa, soybean, orange juice, sugar, alcohol, cotton and tobacco; Brazil's exports of these products are substantial and growing. In addition, the country produces beans, rice, manioc and a large variety of vegetables and fruit for domestic use. Brazil is also a major cattle raising nation.

INDUSTRY

Since the late 1950s, the Government has placed great emphasis on industrial development, basic manufacturing and heavy industry by stimulating investments therein in order to expand industrial capacity. Through exports, Brazilian industries are providing

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Brazil with much-needed foreign exchange, while at the same time upgrading the quality of production for domestic use.

A significant part of Brazil's export revenues are derived from manufactured products such as motor vehicles and spare parts, airplanes, steel, aluminum, textiles, footwear, pulp and paper, etc. Manufactured products today represent 70% of Brazil's total exports.

Brazil's consumer goods needs such as foodstuff, cars, textiles, clothing, tobacco, civil construction, wood, paper, rubber, glass, home appliances, office equipment, chemicals and pharmaceuticals are almost entirely supplied by domestic production.

ENERGY

Brazil produces over 50% of its petroleum needs compared with less than 20% eight years ago. Hydroelectric production has continued to increase considerably over recent years, in addition to the development of alternative sources of energy such as coal, charcoal and alcohol and the more efficient use of energy in general. The decline in world prices for petroleum is favorable to Brazil but even so exploration in the last decade has increased reserves significantly and also resulted in the location of offshore areas of great potential.

In the near future additional capital resources will be required to build power plants to support future economic growth both in industry and agriculture. This could present a problem because the power industry is controlled by the Federal Government that already suffers from an insufficiency of financial resources which is evidenced by the Federal deficits and resulting inflation.

TRANSPORTATION

Two thirds of Brazil's transportation is by road. Considering the long distances to be covered, both the railway network and transportation by inland waterways are inadequate and require development as a means of increasing transportation efficiency and cost reduction.

HIGH TECHNOLOGY INDUSTRIES

The production of telecommunications and electronic equipment is subject to a market reserve system that does not allow the importation of micro and minicomputers and spare parts nor does it allow subsidiaries of foreign companies to produce such equipment in Brazil.

Many Brazilian executives and professionals believe that this protectionist legislation is delaying the country's internal technological development; in fact many believe that the technological gap is widening as a result of this policy and that Brazil is losing ground in this field.

BALANCE OF PAYMENTS

Foreign debt increased from about 100 billion dollars in 1983 to 120 billion in 1988. Although Brazil declared a moratorium in 1986, by mid-1988 it had got back to a more conventional relationship with its creditors in the international financial community. The major part of foreign trade surpluses has been absorbed by interest payments on the country's foreign debt.

CURRENCY AND FOREIGN EXCHANGE CONTROLS

Brazil has a rigid exchange control system and except for a 9-month period in 1986 (when the exchange rate was frozen) the exchange rate has been devalued at frequent intervals. In relation to the United States dollar the Brazilian cruzado suffered mini-devaluations totaling 380% in the year 1987 and 308% in the first 8 months of 1988. These increases reflect the problems of chronic inflation that prevail in the economy.

FOREIGN INVESTMENTS

A number of formalities must be followed in connection with foreign investments, and it is essential that investments either in capital or loans be registered with the Central Bank of Brazil. Foreign currency in Brazil is bought and sold at the official exchange rate, there being no "free exchange". Foreign currency, however, is negotiated on the parallel (illegal) market.

Some restrictions exist in Brazil for foreign investments in certain sectors of the economy (e.g. communications, electronic data processing, informatics, exploration of mineral resources, public utilities, ownership of agricultural property, banking and financial activities and transportation). For some of these sectors, foreign capital may participate with the approval of the Brazilian Government or with a majority Brazilian partner. Restrictions also exist for obtaining local government financing when the local borrower is controlled from abroad.

FOREIGN EQUITY (CAPITAL) INVESTMENTS IN BRAZIL

Present exchange regulations allow the remittance of earnings in the form of dividends or profits to residents outside of Brazil, provided they result from foreign capital investments and reinvestments registered at the Central Bank.

Registration of foreign capital investments at the Central Bank depends on the following general requirements being met:

(a) The foreign investor must be a non-resident of Brazil.
(b) The foreign investor must either have purchased a capital participation in an existing local company

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or have remitted to Brazil foreign currency or capital assets as a contribution to the equity of a local company.
(c) The Central Bank of Brazil will only recognize foreign currency remittances to Brazil that are made through normal banking channels and are exchanged into cruzados in accordance with existing regulations, through an authorized broker.
(d) The importation of capital assets as an equity contribution must have the prior approval of exchange authorities.
(e) The foreign investor, through his capital contribution, becomes and remains a shareholder or a quotaholder in a local company.

The portion of earnings in a local company that relates to the foreign investment and that is capitalized in the same company can be registered at the Central Bank as a foreign currency investment. These "stock dividends" are not subject to the 25% withholding tax or supplementary tax due on cash dividends. Earnings arising from interest income less interest expense do not qualify for registration as foreign capital, except in the case of financial institutions.

PROFIT DISTRIBUTION AND DIVIDENDS ON FOREIGN EQUITY INVESTMENTS

Profits and dividends remittances abroad are permitted with no restrictions provided they result from foreign capital investments and reinvestments registered with the Central Bank of Brazil. Income tax is withheld at source at the rate of 25% each time a distribution of profits or dividends to a foreign legal entity or individual occurs. Lower rates apply when profits are distributed to countries with which double taxation treaties exist.

However, whenever the average of distributions after deducting the 25% withholding tax, within a period of 3 consecutive years, exceeds the percentage of 12% of registered foreign capital and reinvestments, a supplemental tax on the excess is due. This supplemental tax is computed based on a graduated table and is discussed in the next paragraph.

SUPPLEMENTARY INCOME TAX[1]

In accordance with Brazilian income tax legislation, profits distributed to persons or companies resident or located in a foreign country are subject to a supplementary income tax. This tax is triggered by the declaration of dividends payable to foreign shareholders.

The supplementary income tax on the distribution of profits will apply when the average of distributed net profits after deducting the 25% withholding tax for 3 consecutive years exceeds 12% of registered foreign capital. This supplementary tax is computed based on a graduated table, at a rate of 40% on the portion between 12% and 15% of registered capital, 50% on the portion between 15% and 25% and 60% on the portion over 25% of the registered base. The supplementary tax is borne by the recipient and is normally offset against the distribution following the payment of such tax.

This is summarized in the following example of a foreign investment of $ 1,000 that consistently receives an annual gross dividend of $ 400 (40%) that is partly used to cover the supplementary tax on the preceding year's dividend:

Dividend of 40% of registered foreign investment of $ 1,000	$ 400
25% withholding tax	(100)
	300
Deduct supplementary tax on preceding year dividend	(58)
Net dividend remittable	242

Supplementary tax computation

	Basis	*Tax*
Up to 12% exempt	120	–
40% on portion between 12% and 15%	30	12
50% on portion between 15% and 25%	92	46
	242	58

The taxpayer has the right to carry forward distribution rights of one given year for the 2 subsequent years. In other words, if no distribution is made during the first and second year, in the third year the company has the right to distribute and remit net profits of up to 36% of registered foreign capital without incurring the supplementary tax.

The supplementary income tax does not apply if profits or dividends distributed are reinvested in the same company or in any other company established in Brazil, instead of being remitted abroad.

FOREIGN LOANS

Foreign loans may be contracted by Brazilian companies. The following are the main aspects to be considered concerning such loans:

(a) The minimum term is 7 years, with maturities over 5 years.
(b) All interest remitted or credited to a foreign beneficiary is subject to a 25% withholding tax, unless some other rate is stated in a tax treaty with Brazil (usually 15%).
(c) All foreign loans must be registered at the Central Bank.

Borrowers of foreign loans are authorized to deposit equivalent amounts with the Central Bank in order to avoid the related interest and exchange losses.

DEBT EQUITY CONVERSIONS

In view of Brazil's significant level of foreign currency debt, in February 1988 the Brazilian Central Bank

1. For a discussion of supplementary income tax, see in this issue, Pinto, "Brazilian Tax Treatment of Foreign Investments", at 376.

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established certain rules for the conversion of debt into equity.

About one fifth of Brazil's foreign debt has been deposited with the Brazilian Central Bank which means that it is debt that has been paid for and for which the Central Bank is now the debtor.

The rules for conversion of debt into equity enable a foreign equity investor to acquire foreign currency debt from a creditor outside Brazil, at a discount, and receive the cruzado equivalent of such debt from the Central Bank, also at a discount. The effect of this procedure is summarized in the following example:

– Foreign equity investor acquires $ 100 of debt from a creditor outside Brazil at a discount of say 48% – Cost of transaction	$ 52
– Foreign equity investor receives from Central Bank equivalent of $ 100 less a discount of say 19% Received by foreign investor in cruzados	$ 81
– Foreign capital registration	$ 81

The debt must be converted into an equity investment and will receive appropriate foreign capital registration in foreign currency. The equity investments arising from debt conversions may not be repatriated for a period of 12 years. Remittances of profits are subject to the same rules and levels of taxation as those that apply to regular equity investments.

Private debt that is not on deposit with the Central Bank may be converted into equity for the full amount in cruzados but at a discount with regard to the foreign currency capital registration.

The debt conversion procedures are quite complex and therefore require expert advice and direction. It is suggested that as a first step in this regard it is prudent to consult an international banker, attorney or public accountant.

FOREIGN TECHNOLOGY

All contracts for transfer of foreign technology to Brazil must be registered with the National Institute of Industrial Property (Instituto Nacional de Propriedade Industrial – INPI). After registration with the INPI, contracts must also be registered with the Central Bank in order to make remittances abroad and the expense deductible for tax purposes.

The contracts to be registered must describe, in detail, the type of technology being transferred, programs for training of Brazilian nationals and the manner of substantiating payments in the future. Contracts to be registered will only be approved for a 5-year period, with a maximum payment of 5% computed on sales or production.

Payments for the use of patents or trademark rights will not be permitted to a foreign parent controlling more than 50% of the Brazilian subsidiary's voting stock. Payments for technical or administrative assistance to a controlling parent company may be permitted but do not qualify as a deductible expense for income tax purposes.

Payments for foreign technology by Brazilian companies are very limited. Because of the current structure of the INPI, registration of contracts is difficult and time consuming unless the contract relates to a project considered by the Brazilian Government of interest and priority for the economic development of the country.

INFLATION AND INDEXATION

Since 1964 an extensive nationwide system of indexation was developed in order to enable business enterprises and individuals to cope with the effects of inflation that in recent years evolved as follows:

	Percent
1980	110
1981	95
1982	99
1983	211
1984	223
1985	224
1986	62
1987	366
1988 (up to August)	301

On 28 February 1986 an Economic Stabilization Program was enacted with the objective of eliminating inflation. One of the principal aspects of the Program was to virtually abolish the indexation system that evolved in Brazil from 1964 to February 1986. The stabilization program was unsuccessful; many believe that the reason for this failure was that "Federal Government deficit spending" was not eliminated. Indexation was readopted in 1987.

INFLATION – PRINCIPAL ASPECTS OF THE INDEXATION SYSTEM (MONETARY CORRECTION)

The principal aspects of the indexation system in effect are the following:

(a) On the first day of each month the value of the National Treasury Bond (OTN) is adjusted for the effects of inflation in the preceding month based on the consumer price index.

(b) Most indexation procedures (referred to as monetary correction in Brazil) are based on the changes in value of the National Treasury Bond (OTN).

(c) At times the value of the National Treasury Bond (OTN) has not kept pace with the official rate of exchange for the U.S. dollar. This is evidenced by the fact that the dollar equivalent of one OTN declined from US$ 15.68 as of 1 September 1978 to US$ 8.30 as of 1 September 1988.

(d) Corporate entities are required to adjust their financial statements for the effects of inflation based on rules established by the Internal Revenue Service and by the Brazilian SEC (CVM). The Brazilian method

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of accounting for the effects of inflation for tax purposes follows conventional price level or constant value accounting procedures in a simplified form with the objective of restating fixed assets, investments, shareholders' equity and net income to reflect the effects of changes in price levels.

(e) All past-due taxes and fines are subject to monetary restatement.

(f) Tax loss carryforwards may be monetarily restated.

(g) In addition to interest, most loans contracted in Brazil are subject to a monetary correction clause to protect the lender from inflation.

(h) Investments in savings accounts, bank certificates, securities, etc., besides the usual interest rate, also earn monetary correction.

(i) Salary increases are granted monthly for the effect of inflation.

(j) Tax brackets, exemptions for dependents, and other items provided for in the tax legislation are adjusted quarterly for withholding taxes on payments to individuals and once a year for annual income tax returns.

(k) Rentals are generally subject to periodical monetary restatements.

(l) Prices are mostly subject to frequent adjustments in order to cover increasing replacement costs. It is quite common for service contracts to contain an indexation clause based on changes in value of the OTN.

CORPORATE TAXES

INCOME TAX

Brazil generally adopts the concept of territoriality and taxes all income earned within its borders. However, certain specific situations exist in which payments for services rendered abroad are subject to Brazilian withholding tax.

Brazil has signed double taxation tax treaties with Austria, Argentina, Belgium, Canada, Denmark, Ecuador, Finland, France, Germany (Fed. Rep.), Italy, Japan, Luxembourg, Norway, Portugal, Spain and Sweden.

The basic corporate income tax rate is 35%. Taxable profits that exceed the cruzado equivalent of 20,000 OTNs (National Treasury Bonds), in most cases, are subject to an additional 5% tax on the portion of profits up to 40,000 OTNs (in September 1988 the value of 40,000 OTNs was equivalent to about US$ 300,000).

All corporate tax returns are required to be filed as of 31 December. The legal entity's official year end no longer has any effect on the date on which corporate tax returns must be filed.

Most legal entities are required to pay their income tax in 12 monthly installments, 4 prior to the 31 December balance sheet date and 8 after this date. The tax liability is calculated as of 31 December and all 12 installments are adjusted (indexed) for the effects of inflation.

RULES FOR COMPUTATION OF TAXABLE INCOME

Accounting for the effects of inflation

Inflation accounting The Brazilian method of accounting for the effects of inflation, both for tax and financial reporting purposes, follows conventional price level or constant value accounting procedures in a simplified form with the objective of restating fixed assets, investments, shareholders' equity and net income for the effects of changes in price levels.

Index used The index used for measuring changes in price levels is the "National Treasury Bond Index" which in turn is based on changes in the "Consumer Price Index".

Assets Fixed assets and accrued depreciation, investments, deferred charges, foreign currency receivables and local currency receivables subject to indexation are written up for the effects of inflation or exchange devaluation.

Liabilities and shareholders' equity Capital, capital surplus, retained earnings, foreign currency liabilities and local currency liabilities are written up for the effects of inflation or exchange devaluation.

Depreciation and amortization The charges of these costs to taxable income are adjusted for the effects of inflation on the same basis as the related asset accounts.

Exchange losses and gains Unrealized exchange losses on foreign currency liabilities are deductible charges to income – unrealized exchange gains on foreign currency receivable are taxable credits to income.

Exposure to inflation The loss on exposure to inflation is a deductible charge to income. The gain on negative exposure to inflation is a taxable credit to income but may be deferred, at the taxpayer's option, in which case the gain becomes taxable in proportion to the future realization of fixed assets through depreciation or disposal.

Inventory profits To the extent these are caused by inflation, they are, in effect, eliminated from taxable income.

Depreciation Depreciation deductions are generally limited to the following annual rates based on the straight-line method and computed on a cost plus monetary restatements basis: vehicles and computers, 20%; machinery, equipment, furniture and fixtures, 10%; and buildings, 4%. Accelerated depreciation rates may be obtained for extra use such as 2 or 3-shift operations or as a result of tax incentives.

Loss carryforwards Companies' tax losses may be carried forward and used in the 4 subsequent years. Car-

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rybacks are not allowed. These losses are subject to monetary correction.

Inventory pricing Inventories of raw materials and work-in-process must be priced at cost. Finished goods must be valued at the lower of cost or market. Acceptable cost methods include average cost, first-in first-out, and standard cost (if proved to be reliable). The last-in first-out method is not accepted by the tax authorities. Cost applicable to work-in-process and finished goods must result from a cost accounting system integrated with the general accounting records; otherwise, the tax authorities may apply arbitrary pricing rules which will generally increase the amount of inventory for income tax purposes.

Bad debts A bad debt reserve of up to 3% of accounts receivables is allowed. Request for use of a higher rate must be justified by actual experience.

Directors' compensation A limit is imposed on the annual compensation of officers, directors and individual partners for purposes of considering such payments as deductible expenses.

Pension plans Contributions to pension plans which are properly organized and registered by the company with the authorities and which apply to all employees may qualify as deductible expenses.

Equity accounting Companies that have relevant investments in other companies are required to carry such investments for tax purposes on the equity method of accounting. The equity in profits or losses is not taxable or deductible.

Installment sales Installment reporting for income tax purposes is allowed if the payment dates extend beyond the year following the year of sale. This rule applies solely to sales of a company's real properties.

TAX ON EXCESS RESERVES

There is a 25% tax on the amount by which the retained earnings of a Sociedade Anônima exceed the corporation's capital. This tax can be avoided by capitalizing or distributing a sufficient amount to eliminate the excess.

AGENTS AND REPRESENTATIVES

Sales contracted in Brazil by a foreign seller through an agent or representative are normally not subject to Brazilian income tax. The agent is required to report the foreign principal's profit in his income. If he does not, the profit is arbitrarily set at 20% of the sales price. This tax rule applies only if the agent or representative has the legal right to bind the foreign seller contractually.

DIVIDENDS RECEIVED

Dividends received by a Brazilian company are not subject to corporate tax. Intercompany profit distributions within Brazil are taxed at source at the rate of 25%, which can be offset when the recipient company, in turn, pays dividends subject to withholding. This taxation at source does not apply if the recipient of the dividend is a publicly-held or a tax-exempt company.

TYPES OF BUSINESS ENTITIES

The most common types of business entities in Brazil are the Sociedade por Quotas de Responsabilidade Limitada (limited liability company) and the Sociedade Anônima (corporation):

(a) The Sociedade Limitada differs from the Sociedade Anônima in that it requires less formalities concerning its establishment and less public disclosure attached to its formation and operation. The capital structure of the Limitada is more rigid than the Sociedade Anônima. The Limitada has only one type of equity interest (i.e. registered quotas), and their transfer may be difficult under certain circumstances.

(b) The Sociedade Anônima requires more formalities in its operations than does the Limitada. The following must be published: notices of shareholders' meeting, annual financial statements, directors' annual report, and the Articles of Incorporation (together with the minutes of the first shareholders' meeting). If the Sociedade Anônima is publicly held, additional publication and disclosure requirements are imposed by legislation.

(c) Other less common forms of business entities are partnerships, unlimited liability companies and branches of foreign companies.

SOCIEDADE ANONIMA VERSUS SOCIEDADE LIMITADA

If a Brazilian company is to be 100% owned by a foreign investor, it is preferable to form a Sociedade Limitada (mainly because of reduced publication requirements and simplified structure and operation). However, if a Brazilian partner is contemplated, a Sociedade Anônima could prove to be better because of:

(a) Greater flexibility in the form of the equity interest (common voting of preferred non voting shares; nominative or bearer shares). Preferred shares are quite different from the United States because in addition to being assured minimum dividends they generally, but not always, participate on equal terms with the common shares when the minimum dividend is exceeded.

(b) Better planning possibilities concerning cash dividends, shareholders' rights and interests.

(c) The opportunities to go public by selling its shares on the open market.

From a taxation standpoint, certain minor differences exist between the 2 types of business entities.

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LABOR, SOCIAL SECURITY AND OTHER SOCIAL TAXES

Employment and labor practices in Brazil are generally governed by the Consolidated Labor Laws. The normal work week in Brazil is 44 hours over a 6-day period. Fringe benefits for employees increase a company's payroll costs by about 70%. Some of the benefits and social charges are:

(a) Employers must deposit monthly an amount equal to 8% of each employee's gross salary in a blocked bank account for payment of employee severance rights. Employees dismissed are allowed to withdraw the balance on their blocked bank account and also receive a termination indemnity from the employer, equivalent to 40% of the balance on the blocked bank account.

(b) Employees get one month as a paid vacation after working a full year. At the time of taking vacation employees are also entitled to a bonus of 33% of one month's salary.

(c) A "thirteenth month" bonus, of one salary, is mandatory.

(d) Employers contribute 10% of gross payroll per month to the social security program, and employees from 8.5% to 10% up to a limit of 20 times the minimum monthly salary.

(e) Female employees are entitled to 120 days maternity leave upon birth of a child.

(f) Employers must provide for sick pay for the first 15 days of sick leave.

The minimum wage is equivalent to about US$ 54 per month and the cruzado amount is increased monthly for the effects of inflation.

Social Integration Program (PIS) gives employees a chance to benefit directly from the country's economic growth, participating in business profits, through a mandatory national saving program financed by monthly deposits computed as a percentage of sales (0.65%).

Social Investment Fund (FINSOCIAL) is a plan for special social programs to be funded based on a tax as a percentage of sales (0.5%) or annually at 5% of income tax in the case of service companies.

Employment and labor practices are governed by the Constitution and the Consolidated Labor Laws, which control, among other things, working conditions and collective bargaining. In recent years Brazilian trade unions have assumed an important role in the collective bargaining process. The trade unions have grown in competence and in stature and are taken seriously by management and the new Constitution has virtually eliminated all restrictions on workers going on strike.

SALES, EXCISE AND SERVICE TAXES

FEDERAL TAX ON INDUSTRIALIZED PRODUCTS (IPI)

This excise tax is paid by manufacturers on behalf of their customers at the time of sale, either to another manufacturer who will further the manufacturing process or to the retailer or ultimate customer. The tax paid is stated separately on the sales invoice and is in the nature of a value added tax. The IPI tax rate varies according to the nature of the goods involved. Certain exemptions are given to goods considered to be of basic necessity to the economy.

As mentioned above, when manufactured products are sold between producers, the IPI is imposed. However, a subsequent manufacturer is allowed a credit against its IPI liability, equal to the IPI it paid to its suppliers. The tax on industrialized products is clearly in the nature of a value added tax.

STATE TAX ON CIRCULATION OF MERCHANDISE (ICM)

This sales tax is also a value added tax and is collected by most states at the rate of 17% with special rates for interstate and export sales. A credit against taxes payable by the seller is allowed for taxes paid on materials purchased. The state tax is charged on the value added to the goods in each transaction.

MUNICIPAL TAX ON RENDERING OF SERVICES (ISS)

This service tax is collected by most of the large municipalities at a usual rate of 5% of the charge for services rendered which are listed by Federal Statute.

FOREIGN TRADE AND EXPORT INCENTIVES

Due to its large external debt, Brazil has made a great effort in recent years to generate and increase its foreign trade surplus. The country recorded trade surpluses that averaged US$ 10.3 billion in the 5-year period from 1983 to 1987 and is expected to exceed a US$ 17.0 billion surplus in 1988.

The significant trade surplus is necessary for the country to generate sufficient foreign exchange to pay for the significant interest charges on foreign currency debt. Exports are encouraged by various kinds of export incentives.

Brazilian legislation provides for a substantial number of tax incentives for certain types of exports (mostly for products manufactured in Brazil). The main incentives are:

(a) Exported manufactured products are exempt from excise (IPI) and sales (ICM) taxes. Income generated

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from exports is taxed at a special rate of 3% in 1988 and 6% in subsequent years.

(b) Remittances abroad for advertising, exhibits at trade fairs, expositions, etc. of Brazilian manufactured products are exempt from the 25% withholding tax.

(c) Remittances abroad for payment of commissions on exportations are also exempt from the 25% withholding tax.

(d) Remittances abroad for payment of commissions and interest on loans destined to finance exports, under certain conditions, are exempt from the 25% withholding tax.

(e) Imported equipment or raw materials for production of goods to be exported (drawback) can, under certain conditions, benefit from exemption or reduction or excise tax and customs duties.

INVESTMENT INCENTIVES

There are basically 2 types of fiscal incentives granted by the Brazilian Government.

The first type includes the exemptions and privileges which are given to companies that are either doing business in underdeveloped areas in Brazil or are engaged in economic activities which are considered essential to the country's economic growth. These exemptions and privileges fall into the areas of income tax, IPI and ICM taxes, import duties, exports and price controls.

The second type of incentives are tax credits for investments in certain business activities. Specific economic areas which may qualify for tax incentives:
(a) Fishing
(b) Agricultural and animal husbandry
(c) Forestation and reforestation, etc.

INDIVIDUAL INCOME TAXES

Individuals residing in Brazil are subject to tax on all income regardless of where earned. Income generated from assets abroad will not be taxed in Brazil during the first 5 years of permanent residence by foreign individuals if all assets are declared to the fiscal authorities when arriving in Brazil or when filing the first income tax return. In theory, a foreign tax credit is allowed to individuals for taxes paid to other countries on income earned outside Brazil which is also taxable in Brazil, providing reciprocity exists in the other country regarding Brazilian taxes. However, in practice, it has been difficult to obtain approval for the credit. When permanently leaving Brazil, special procedures should be followed in order to avoid any subsequent tax liability.

Most income is taxable except for gains on publicly traded stocks and bonds and certain personal property. As part of their annual income tax return, individuals are required to report all assets and liabilities in and outside of Brazil.

A foreigner is considered to be a resident for tax purposes if he has a permanent visa to stay in Brazil. An individual who has a temporary visa will also be considered a resident if he stays in Brazil for a period of more than 12 consecutive months.

Individual tax rules generally change annually. Rates applicable to 1987 ranged up to 50% on income in excess of Cz$ 2,136,600.00 (equivalent to US$ 54,000 at the average rate of exchange for the year 1987).

The individual tax returns are filed on a calendar year basis and except for medical and hospital expenses and donations to Brazilian charities all other allowable deductions are not significant in relation to higher salary levels.

Tax returns must be filed by the end of April of the following year and the balance of tax due then either be paid when the return is filed or in up to 8 installments, at the option of the taxpayer, on a monthly basis beginning in April but subject to monetary correction for the effects of inflation.

Monthly compensation received from Brazilian sources is subject to a withholding income tax based on a progressive scale that goes up to 45%. The withholding tax deductions at several levels of income in the month of August 1988 were the following (conversion to dollars at Cz$ 292.00 per US$ 1.00).

Monthly salary

Cruzados	Dollar equivalent	Withholding income tax	Percentage of tax
292,000	$ 1,000	$ 140	14.0%
584,000	$ 2,000	$ 410	20.5%
1,168,000	$ 4,000	$ 1,171	29.3%
1,752,000	$ 6,000	$ 2,071	34.5%
2,336,000	$ 8,000	$ 2,970	37.1%
2,920,000	$ 10,000	$ 3,871	38.7%

Allowable deductions from monthly salaries, for purposes of the above computations, are not significant at the higher income levels.

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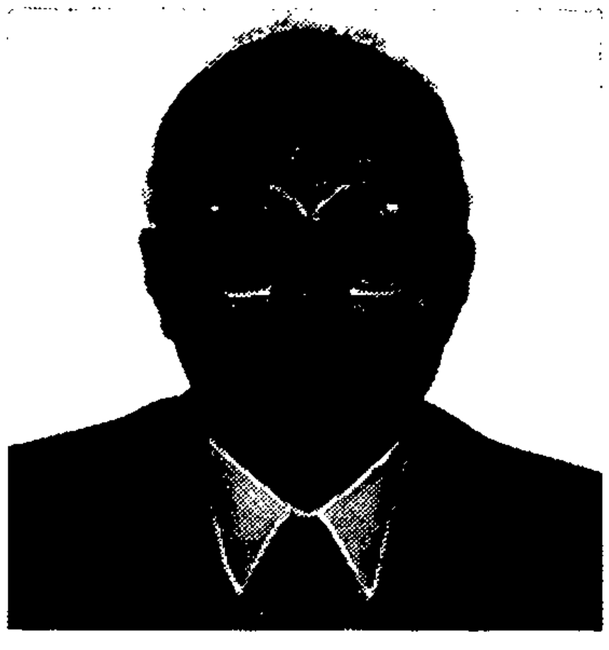

Tax Policy in Brazil

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Developing tax policy is a function of the executive and legislative branches of government in that it concerns the ultimate form of the tax burden. Tax policy defines the origins of funding through tax revenues, independently of whether the resources are to be channelled to the Treasury or utilized as an economic policy instrument. Although the process is normally initiated at the level of the executive branch, in democratic countries the final word on fiscal policy is the province of the National Congress. It is the task of the representatives of the people to define how public expenditures are to be financed as well as to indicate the tax burden of each social sector.

The decision of who should pay taxes is an extremely difficult one and it is only through Parliament that one can obtain the agreement of taxpayers to surrender part of their resources for the benefit of the state as a whole. It is through tax policy, for example, that one determines whether profits, earnings and capital gains should be subject to a greater tax burden than the earnings derived from labour. Parliament resolves these issues.

State intervention in the economy is primarily exercised through taxation. Taxes are nothing more than the transfer of resources from the private sector to the public sector. What should be the level of this intervention? How are revenues to be obtained for the State? Should they be obtained through heavier taxation of companies and individuals (direct taxes) or by imposing the tax burden on merchandise, products and services (indirect taxes)? Is it worth utilizing the tax system as a means of stimulating the regional and sectoral economy, or would it be better to abolish the entire complex of exemptions and fiscal incentives in such a way so as to stamp a character of greater transparency on the Budget, thus making it possible for the public to know who is receiving the funding handed over to the government and how it is being invested? These questions as well are resolved through tax policy.

THE NATIONAL TAX SYSTEM IN THE 1967 CONSTITUTION

Until the advent of the 1988 Constitution, the development of the tax system in Brazil could be separated into 3 distinct historical stages. Between 1891 and 1934, the financial composition of Brazil in terms of tax revenues favoured the autonomy of the member States, since at that time the Municipalities were not autonomous. It was a highly flexible tax system that even permitted double taxation in the legal sense, i.e. it allowed the cumulative charging of the same type of tax by the Federal and State governments. The tax system introduced as of 1934 survived the 1946 Constitution and lasted until the reform which was introduced in 1965 and implemented in 1967. This period was marked by more rigid limitations on the financial autonomy of the States and the definition of a specific taxing authority for the Municipalities. It prohibited double taxation and eliminated the residual authority that allowed for the institution of taxes at the discretion of the Federal and State governments. Albeit in rather embryonic form, it implemented a system of distribution of tax revenues from the Federal to the State and Municipal governments. The 1946 Constitution introduced few modifications into the 1934 system. One item of importance was the institution of excise taxes charged by the Federal government on lubricants, fuels, minerals and electrical energy. Sixty percent of the total revenue from these taxes was distributed to the States and Municipalities. At the same time, 10% of income tax revenue was transferred to the Municipalities.

The defects and incongruities of the 1934/46 tax system can be outlined as follows:

- absence of a truly national characteristic capable of integrating and harmonizing the levels of Federal, State and Municipal taxation. Consequently, there were constant conflicts among the States that were transformed into a veritable "fiscal war";
- no compatibility between the taxing authority and the institutional objectives of the 3 taxing entities. Although the Federal government was clearly responsible for the formulation of national economic policy, several important taxes which could have fostered this policy were part of the taxing authority of the States;
- the definition of the factors giving rise to tax liability was tied more to juridical aspects than to economic aspects. This represented a serious lack of rationality since, by the very principle of taxation, the taxes should be levied on the basis of facts that reveal contributory capacity for the payment of taxes;

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- non-utilization of taxes as an instrument of economic and social policy in adverse economic situations. The now common concern with fostering regional and sectoral development and redistribution of national income through taxation simply did not exist.

It was in light of this situation as well as the new economic reality emerging in Brazil that the 1965 tax reform was adopted.[1] The reform culminated in the 1967 Constitution. The reform represented a reaction to the classical tax system of the 1946 Constitution, which concerned itself exclusively with the fiscal aspects of sharing authority to impose taxes, while ignoring the social and political aspects of tax.

The objectives of the 1965 reform can be summarized as follows:

- creation of a tax system that, by precisely defining the taxing authority of each administrative entity (Federal, State and Municipal) at the constitutional level, could effectively harmonize and integrate taxation in national terms so that the Federal government, the States and Municipalities could adequately perform their tasks;
- consolidation of taxes to avoid overlapping and ambiguities and reduce the inherent unfairness in the distribution of the tax burden;
- reformulation of instruments and mechanisms to enable utilization of taxes for extrafiscal purposes, i.e. to influence the economic development of regions and sectors and foster improved distribution of income;
- in light of the Federal government's natural vocation as the locomotive of national economic policy, establish a more rational system of tax collection and automatic redistribution of resources to the other 2 levels of government;
- make the national tax system more progressive through fair imposition of income tax, i.e. those with more ability to pay income tax should do so and the less favoured economic groups should be granted relief.

In keeping with these objectives, taxes were allocated into 4 groups that were representative of the economic system:

Taxes on Foreign Trade
- Import Tax (II)
- Export Tax (IE)

Taxes on Assets and Income
- Tax on Ownership of Urban Buildings and Land (IPTU)
- Tax on Ownership of Rural Land (IPTR)
- Tax on the Transfer of Real Estate and Rights to Real Estate (ITBI)
- Tax on Income and Earnings of Any Nature (IR)

Tax on Production and Circulation
- Tax on Transactions Involving the Circulation of Merchandise (ICM)
- Tax on Manufactured Products (IPI)
- Tax on Financial Transactions (IOF)
- Tax on Transportation (ITR)
- Tax on Communications (ICD)
- Tax on Services of Any Nature (ISS)

Special Taxes (Excise Taxes)
- Tax on Electrical Energy (IUEE)
- Tax on Fuels and Lubricants (IULCLG)
- Tax on National Minerals (IUM)
- Extraordinary Wartime Taxes

In addition to the modifications in the authority to levy taxes (coupled with the elimination of some taxes and the reformulation and institution of others), the 1965/67 reform established the residual authority of the Federal government to create new taxes, provided that the factor giving rise to the taxes was not identical to that of the State and Municipal taxes.

The reform was characterized by the concentration of taxing power in the hands of the Federal government as a consequence of the number of taxes attributed to the Federal government and the inflexibility of the State and Municipal taxing authorities. In more specified terms, only 2 taxes were left to the States, i.e. the tax on transactions involving the circulation of merchandise (ICM) and the tax on the transfer of real estate and rights to real estate (ITBI); 2 other taxes were left to the Municipalities, i.e. the tax on urban buildings and land (IPTU) and the tax on services (ISS). State and Municipal authorities were restricted even in the case of these 4 taxes because the Federal government was empowered to grant exemptions from these taxes through supplementary legislation. Additionally, the maximum rates of the ICM and ITBI were set by Federal Senate Resolution based on a proposal sent by the President of the Republic. The maximum rate of the ISS was determined by supplementary legislation.

This centralization of taxing authority had clear objectives. While the Federal government retained the largest share of taxing power, a constitutional mechanism was structured to channel a significant share of the collected revenues to the other political entities. The principal components of this system were as follows:

(a) the State and Municipal Revenue Sharing Fund, composed of part of the revenues collected through the tax on earnings and income (IR) and the tax on manufactured products (IPI);
(b) State and Municipal participation in the collection of excise taxes on electrical energy, lubricants and fuels and national minerals;
(c) distribution of all revenues collected through the tax on transportation (ITR) to the Municipalities;
(d) investments in regional development projects, particularly in the north and northeast of the country, and in projects aimed at the development of specific sectors of the economy (e.g. tourism, fishery and forestation and reforestation programs) take the form of fiscal incentives originating in the income tax.

1. Constitutional Amendment No. 18.

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DISTORTIONS IN THE OBJECTIVES OF THE 1965/67 REFORM

Some of the basic objectives of the national tax system were never achieved and the system as a whole was never fully implemented in its original form. The reform was understood more as an ideal to be gradually attained through a process of constant and progressive improvement of tax legislation, always with due attention to the overall requirements of the Brazilian economy. As explained below, the fundamental ideas of the 1965/67 reform underwent a process that resulted in significant distortions.

A case in point is the income tax, which had been conceived of as a dual purpose instrument, i.e. to collect revenue and to foster economic and social development. The major distortion occurred with respect to the first of these objectives because an excessive number of regional and sectoral incentives were created which provoked a decline in the revenue from income tax and – even more serious – reduced the progressive nature of the tax in such a way as to benefit those in higher income brackets. This was precisely the opposite of the originally desired goal. Other deviations also occurred, such as:

(a) institution of a tax system that was highly favourable to income earned by personal holdings and beneficiaries of capital earnings and gains which, inevitably, resulted in a system that heavily taxed the fruits of labour;
(b) ignoring the aspects of cost minimization, taxes were uniformly and indiscriminately levied on small, medium and large companies. Because of economies of scale, the large companies were able to achieve comparative advantages and were more efficient in administrative and operational terms;
(c) taxation of illusory earnings of businesses because adequate mechanisms to neutralize the effects of inflation on business earnings did not exist;
(d) differentiated treatment as regards withholding tax on specific types of earnings from labour and some capital gains because the earnings of liberal professionals and the income from property rentals were not subject to withholding tax at source;
(e) as a result of the system adopted to define the moment at which an event giving rise to income tax occurs, there was a large gap between the moment of calculation of the taxable base of individuals and legal entities and the effective payment of the tax. This effect was caused by the inflationary process and provoked losses both for the taxpayer (when he was entitled to a tax refund) and the taxing authorities (in the case of taxes due).

The vast field of goods upon which the IPI was levied caused major distortions. The IPI was instituted as a selective tax to be charged on the basis of whether a product was of essential importance to the consumer. However the general manner in which it was imposed neutralized the objectives of the IPI and made it an unfair tax because it was indiscriminately levied on non-essential goods and products of basic necessity.

The ICM, which was designed to be the major source of revenue for the States that would enable them to achieve their coveted goal of financial autonomy, was seriously undermined because of the numerous exemptions granted by agreement for various products. Additionally, the ICM rates on domestic operations were reduced from 18% to 15% in the north/northeast in 1968 and from 17% to 14% in the central/south region.

Mention should also be made of the adverse impact of the deterioration of the distribution of Federal government tax revenue through the Revenue Sharing Funds. Originally, it was determined that 20% of the IPI and IR income would be transferred. However, this rate was gradually reduced until reaching a level of 10% in 1969, or just half of the originally programmed percentage. The transfer system of the Revenue Sharing Funds became subject to vast bureaucratic tangles, particularly when it was determined that the resources would only be released to specific projects being carried out by the States and Municipalities.

Since the power of the States and Municipalities to broaden the range of their taxes was highly inflexible, the participation of the Federal government in total revenues collected increased sharply.

It should also be observed that the percentage of the tax on fuels and lubricants (IULCLG) to be distributed to the States and Municipalities (originally set at 60%) was later reduced to 40%; the States and Municipalities were permitted to charge the ICM on these products. The latter possibility, however, was soon withdrawn although the 60% level of distribution was not restored.

Parallel to this, one of the fundamental objectives of the 65/67 reform – that of reducing the number of taxes – was also undermined when the Federal government was granted the power to institute the so-called parafiscal contributions (or social contributions) for purposes of intervention in the economic domain or the interests of specific professional categories and to meet the requirements of the current expenditures of the social security system for which the Federal government is liable. This power gave rise to the Fund for the Guarantee of Employment Time (FGTS), Social Integration Program/Social Integration and Assistance Program for Government Employees (PIS/PASEP), the Education Salary and FINSOCIAL, some of which are true contributions, while others have been recognized by the judiciary branch as true taxes with all of the negative aspects as regards double taxation and the reappearance of the so-called "cascade" system of taxation.

On the basis of what has been stated above, it can be concluded that, as a result of circumstances, the ideals of the reform were seriously distorted. The States and Municipalities (who were in dire need of financial resouces) demanded amendments to the system. Society as a whole also demanded that the tax burden be more equitably distributed. Obviously, one cannot deny that the 1967 tax reform brought about crucial changes to

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the previous system and these changes had much to do with Brazil's economic development process. The utilization of taxes as a means to further regional and sectoral development was, without a doubt, the base upon which the expansion of Brazilian industrial activity and the penetration of important international markets were founded.

CORRECTION OF SOME DISTORTIONS

As problems began to manifest themselves, the distortions of the system became evident and urgent corrective measures were taken. Many of these measures can be considered as mini-reforms that were aimed at achieving greater equilibrium in the system so that it would once more recover its original objectives.

The modifications included the following:

- Almost all of the exemptions that benefitted capital earnings were revoked. The fiscal incentives available to individuals and that favoured taxpayers in the higher income brackets were drastically reduced.
- To offset the drop in the tax revenue provoked by these measures, the level of taxation on capital earnings and gains was increased as were the taxes on the results of financial applications and profits on the transfer of real estate and business participation.
- A system of tax exemptions applicable to microbusinesses was implemented, while the simplified system of taxation on small and medium businesses was expanded. As a corollary to this measure, the taxation of large companies was increased, principally in the case of those companies which are part of financial institutions.
- Liberal professionals and lessors were obliged to anticipate payment of income tax on their earnings, thus extending the tax treatment applied to salaried workers to the gains received on these types of activities.
- The mechanisms aimed at avoiding the taxation of profits of legal entities that result from the inflationary process were perfected.

As a result of these measures, the profile of the distribution of the tax burden on the earnings of labour and capital was significantly altered. This is evidenced by the fact that, in the 1988 fiscal year, the taxation of earnings of labour accounted for only 30.9% of the total income tax revenue, while capital earnings accounted for 68.7%. The alteration of this profile takes on even greater significance when one notes that the income tax accounted for 41% of Federal government revenues in 1988, as compared to a 1973 total of 29%.

The deviations that occurred in the case of the IPI as a result of the broadening of its field of application were corrected through changes in the legislation in 1979. As a result of these amendments, more than 4,000 products were exempted from the IPI, thus benefitting thousands of small and medium-sized businesses responsible for the production of these goods. At the present time, 70% of the IPI revenue comes from the taxation of the few products considered to be non-essential (perfumes, cigarettes, etc.) or items which reflect the purchasing power of the consumer (automobiles, home appliances, toys, etc.).

Several measures were also adopted to ease the hardships faced by the States and Municipalities as a result of the reduction of their taxes:

- ICM rates were increased to 17%, while the scope of items subject to the tax was broadened to include capital goods and imported materials. At the same time, the value of the IPI on cigarettes was included in the calculation base of the ICM.
- The percentages of the income tax and IPI channelled into the formation of the Revenue Sharing Funds of the States and Municipalities and the Special Fund, which had been reduced to 10% in the 69/75 period, were restored to 20% in 79/80, before being increased to 28% in 1984 and 32% in 1985.
- The percentage of the tax on fuels and lubricants channelled to the States and Municipalities was gradually increased from 40% to 60%.

The measures were of particular importance to the different units of the federation when one considers that, in most Brazilian States, tax revenue transfers (including income tax fiscal incentives) represent the largest share of revenue. By way of example, in the 14 States and territories of the north, northeast and central west regions, the resources of these transfers are more than the volume of revenues collected locally by the Federal government. In many of these States, transfers of Federal government tax revenues are, in value terms, more than the tax volume collected by the States themselves.

One should also observe that legislation has streamlined the system of revenue transfers to the States and Municipalities so that the resources now flow to these units in a simpler and more automatic manner.

1988 TAX REFORM

Of all of the subjects discussed by the National Constituent Assembly, the chapter related to the Tax System was perhaps the most hotly debated. Involving the most varied possible interests, tax reform suggestions ranged from those based on exhaustive research to others that were much less well-founded. The States and Municipalities desired greater autonomy based on either greater volumes of resources or enhanced taxation authority. The Federal government insisted on the need for reviewing its responsibilities so that more resources could be transferred. Workers defended the idea that salaries are not income and therefore these earnings should not be subject to income tax.[2] The productive sectors of the economy understood that

2. The workers' argument against taxing salaries cannot be included in any classical discussion on the nature of income. In Brazil it has been used time and again by workers' unions as a slogan when trying to put together pressure groups to force Congress and other administrative bodies to approve their policies during the discussions of changes to the income tax.

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significantly higher taxation on profits of legal entities would result in the transfer of even larger volumes of resources from the private sector to the public sector, thus hampering investments required for a free enterprise system. Farmers felt that their activities should be free of taxation in order to achieve maximum production. The north and northeast regions defended the maintenance of regional incentives, affirming that both regions were attaining development precisely because of the incentives. The States of the southern and eastern regions complained that the volume of resources in the region were being transferred to other regions.

After almost 2 years of discussion, the new Constitution was elaborated and a new tax system was created for Brazil. In his defense of the new tax order, the Chairman of the Committee on the Tax System, Budget and Finance stated:
"in the field of taxation, the draft of the Constitution seeks to combine the fundamental criteria of:
(a) decentralization and strengthening of the autonomy of the States and Municipalities;
(b) attenuation of regional imbalances;
(c) enhanced fiscal justice and taxpayer protection;
(d) simplification and adaptation of taxation to the needs of modernization of the productive system;
(e) guarantee of a minimum degree of national uniformity in the basic principles of the system through preservation of supplementary legislation in the area of taxation.

The effort to decentralize and strengthen the States and Municipalities is evident principally in the broadening of the base of the ICM and in the increased flexibility granted in the definition of ICM rates, in the broadening of the residual authority of the States and in the creation of the sales tax for the Municipalities; at the same time the Revenue Sharing Fund of the States and Federal District (FPE) and the Revenue Sharing Fund of the Municipalities (FPM) were significantly increased. Though less significant, the share of the IPI channelled to the States and Municipalities was also increased, while the States were permitted to charge an additional 5% of the income tax. The earmarking of transfers to predetermined investments was prohibited while mechanisms were created by which representatives of the States and Municipalities were permitted to monitor the calculations and releases of the transferred resources and the process of decentralization of functions and activities. The right of the Federal government to grant exemptions from State and Municipal taxes was eliminated. A decentralization fund based principally on the resources of FINSOCIAL was created. It is hardly necessary to state that this process of decentralization is essential to the achievement of the basic financial equilibrium that should exist among the 3 levels of government of the federation.

The effort to correct regional imbalances is evident not only in the increase of the FPE and FPM, but also in the preservation of the special Fund for the North-Northeast which, according to the draft of the Constitution, has the purpose of channelling investments into these regions through government development institutions. As is already known, the FPE and FPM are distributed in such a way as to benefit the less developed regions, States and Municipalities.

Fiscal justice is expressed through the principle of a more progressive tax system that will take concrete form through supplementary and ordinary legislation. The Constitution is not the proper forum to set rates or to foster the broadening of the scope of the income tax, which is necessary for the attenuation of the regressive social nature of the tax burden. Enhanced taxpayer protection should be expressed in a transparent way by restricting compulsory loans to cases of public calamity, by subjecting the social contributions and intervention in the economic domain to the principles of legality and prior debate, by prohibiting the granting of fiscal privileges to specific professional categories, by protecting taxpayers from abrupt changes in the system and limiting the legal privileges of the Treasury to the detriment of the taxpayer. The potentially progressive nature of the new system is further strengthened by the possibility of greater selectivity of the new ICMS and the introduction of an inheritance tax and a tax on gifts. Furthermore, it should be noted that the sales tax for which the Municipalities are responsible was limited to a maximum of 2%, until such time as the subject is dealt with in supplementary legislation.

The simplification of the tax system is evident in the merger of 7 excise taxes on merchandise and services into a single non-cumulative value added tax. The importance of this measure for industrial exports is obvious since they will benefit from immunity from the taxes that had previously been built into their costs (for instance, the excise taxes on services, fuels and energy). At the same time, the creation of new cumulative taxes is prohibited, special fiscal treatment is to be granted to micro-businesses and fiscal incentives are subject to evaluation by the legislative branch."

This draft was approved with only slight modifications and it was included in the constitutional text. As a result, the Federal government remained responsible for the following taxes: the taxes on imports and exports, the income tax, the tax on industrialized products, the tax on financial transactions, the tax on rural property and large fortunes. The States were granted authority to institute the inheritance tax and the tax on gifts, the tax on transactions involving the circulation of merchandise, the tax on interstate and intermunicipal transportation and communications (ICMS) and the tax on the ownership of automobiles, as well as an additional amount of 5% of the income taxes paid to the Federal government by individuals and legal entities on profits, capital gains and earnings. The Municipalities were granted taxing authority over the following: urban buildings and land, transfer of real estate between living persons, retail sales of liquid and gaseous fuels and services of any nature.

The new tax system has introduced significant altera-

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tions that have had a strong impact on Federal government revenues, i.e. many taxes were transferred from Federal authority to the States and the sharing of tax revenues was amended, resulting in a sharp growth in the percentage of revenue channelled to the States and Municipalities through the Revenue Sharing Funds. This participation will gradually increase to 47% of the revenue from income tax and the IPI, including the 3% set aside for investments in the productive sector of the north, northeast and central west regions. Ten percent of the IPI will be transferred to the States, Municipalities and Federal District, in proportion to their respective exports of industrialized goods. The Federal government was granted residual authority to institute other taxes through supplementary legislation, provided that the taxes are not cumulative in nature and not based on the same facts or calculation bases as those listed in the Constitution.

Under the new system, the Federal government loses authority over 5 taxes which have now been incorporated into the new ICMS and for which the States are responsible, i.e. the tax on transportation, the tax on communications, the excise tax on fuels and lubricants, the excise tax on electrical energy and the excise tax on minerals.

Only the following taxes will remain under the auspices of the Federal government authority: the tax on manufactured products (IPI), the tax on income and earnings (IR), the tax on imports and exports (II and IE), the tax on financial transactions (IOF) and the tax on large fortunes. Among these, only the IR and IPI are financially significant. The other 3 (II, IE and IOF) taxes have an extrafiscal character and are not primarily sources of revenue.

As it was conceived, the system could increase the tax burden because of the overlapping of some taxes and not as a result of Federal government efforts to recompose its sources of income.

Under the previous system, the available revenues of the 3 levels of government were as follows: 39% for the Federal government, 41% for the States and 20% for the Municipalities. The new system should result in the following profile: 30% for the Federal government, 47% for the States and 23% for the Municipalities.

At the constitutional level, the loss of Federal government revenue was not matched by a corresponding transfer of responsibilities to the States and Municipalities. On the contrary, the responsibilities of the Federal government were increased by inclusion of the expenditures involved in the creation of new States, the expenditures of free public education, electoral campaign outlays, the expansion of the federal judiciary system, retirement pensions, and so forth. The levels of revenue entitlement were also increased: 2% of tax revenue to culture; 18% for education and 3% for the Federal judiciary system.

There is a need to establish better equilibrium between the taxing authorities and the responsibilities defined in the Constitution and the financial means required for the carrying out of such responsibilities.

RECENT AMENDMENTS AND THE TAX POLICY OUTLOOK IN BRAZIL

No matter what its characteristics, the tax system which Brazil has adopted represents a new concept, and society and government are going to have to adapt accordingly. The country is currently experiencing a serious economic crisis. Tax policy can and should be a fundamental factor to overcome these difficulties. One cannot lose sight of the basic objectives of any tax system: obtain the resources required for the State to provide society with the required services, foster social justice, and provide a mechanism capable of furthering and inducing economic development, which is an essential element for attainment of the first 2 goals.

Parallelling the promulgation of the new Constitution and, in some cases, as a consequence of it, several measures have been implemented or are being implemented through ordinary legislation.

A case in point is the income tax legislation as applied to individual taxpayers, which went into effect on 1 January 1989. Prior to these changes, Brazilian tax legislation had become so sophisticated and complex that it required excessive taxpayer time and effort to fulfill tax obligations. The highly complex structure of the income tax affected all taxpayers. As proof of this declaration, it is only necessary to state that 60% of those presenting tax returns were responsible for only 3% of the revenue of taxes paid by individuals (approximately 5 million taxpayers). No less compelling was the issue of the unequal distribution of the tax burden. As a result of different mechanisms then included in tax legislation, earnings from labour were taxed differently from the taxation of capital earnings and gains. This situation led to increasing dissatisfaction on the part of salaried taxpayers in relation to the norms governing taxation and created a situation of almost hostile relations between authorities and taxpayers.

High tax rates encouraged taxpayers to seek means to avoid payment. The existence of a complex body of legislation, characterized by a multiplicity of deductions and adjustments, favoured procedures that resulted in undue tax reductions which taxpayers often used unconsciously since they simply were not aware of the infinity of rates that governed each specific item of their tax returns.

The legislation then in effect was derived from periodic adaptations (often adopted in light of very limited group interests) which, with the passing of time, disfigured the taxation of capital earnings and gains, marked particularly by deviations from the basic principles that should govern this form of obtaining budgetary resources.

Taking these deviations into account, the basic objectives of the changes introduced into income tax legisla-

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tion were as follows: (i) simplification of the rules governing the levying of this tax; (ii) reduction of the tax burden on the earnings from labour; and (iii) equal fiscal treatment of the earnings from labour and capital. Despite having its own specific characteristics clearly adapted to the Brazilian reality, the new law followed the global trend of reducing the number of tax brackets and broadening the taxable base through the elimination of adjustments and deductions.

Consequently, as of January 1989, taxes are due on a monthly basis as capital earnings and gains are received. In periods of high inflation, the lag that exists between the moment in which the taxpayer receives the earnings and that in which the tax is paid results in a situation in which the tax is reduced as the time lag increases. Consequently, salaried taxpayers, who pay their taxes on a monthly basis, are subject to a tax burden that is significantly greater than those who pay part of their taxes or even all of their taxes in the fiscal year subsequent to that in which the earnings were received. The monthly calculation of taxes is, therefore, justified so that the value of the tax burden will not depend on the process of inflation and all types of earnings will be taxed in an identical manner no matter what the level of inflation.

The tax is now levied on gross earnings, with no deductions except in special cases defined by legislation. Most tax deductions were eliminated in order to simplify the legislation. Any exceptions to this rule would jeopardize the simplicity of the project since exceptions would necessitate creation of new control systems, i.e. rules, paperwork and forms are precisely what the new legislation sought to avoid. At the same time, as a consequence of the elimination of deductions, the tax rates were reduced significantly.

On 1 July 1988, the tariff reform defined by the Customs Policy Commission went into effect, altering the rates of the import tax. The reform was preceded by a wide-ranging review of the so-called "special import systems" (tax exemptions or reductions on imports of specific goods) and the elimination of non-tariff levies. The principal objectives pursued by the 1988 Tariff Reform were the updating of the tariff system, modernization of foreign trade policy, improvement of tax policy and administrative modernization.

The system of customs protection in effect before 1 July 1988 was marked by many distortions that had negative impacts on the efficiency of the domestic economy and the competitiveness of external trade. The old tariff system had been created in 1957 and, despite numerous amendments introduced over the last 30 years, still reflected many of its original characteristics. Under the previous tariff system, the nominal rates were excessively high and averaged approximately 51% with a maximum rate of 105%. The reform implemented by the Customs Policy Council (CPA) resulted in significant rate reductions, lowering the maximum tariff level to 85% and the average rate to 41%.

Recently, the President of the Republic approved a study that proposes a further review of the levels of the import tax established by the 1988 Tariff Reform since the rates resulting from that reform are still quite high and characterized by excessive protection in many cases.

The National Congress is also analyzing a bill presented by the executive branch that seeks to amend the system of taxation levied on agricultural earnings. About 20 years ago, a system of tax benefits was adopted with the aim of encouraging agricultural activities. This system was based on the utilization of investment multipliers applied to expenditures made specifically in rural activities and had the objective of reducing the calculation base of the income tax on the result thus obtained.

With the evolution of Brazilian agriculture – as it became integrated into the national and international markets – the efficiency of the incentive system was lost and no longer contributed to the resolution of the grave problems faced by the public authorities in this sector, particularly as regards the demand for financing different stages of farm activity. Furthermore, since the system favoured expenditures effected it led not only to distortions in the allocation of resources but became extremely difficult to control since it was applied to each individual taxpayer and not to entire segments of this activity, thus resulting in a significant degree of tax evasion and losses to the Treasury.

To restore the efficiency of the fiscal system and adapt the taxation of the rural sector to the individual income tax reform, a bill was presented which basically reformulates the levying of the income tax on the results obtained through rural production activities, replacing the system of incentives inherent in the previous multipliers with benefits that effectively meet the needs of Brazilian farmers. In this sense, the incentive of reducing the tax calculation base was maintained but it was made subject to the maintenance of resources by farmers in savings accounts reserved for the financing of rural sector activities.

Following the example of the income tax reform applied to individual taxpayers, profound modifications in the tax system applied to legal entities are to be presented in the near future. The fundamental guidelines of these amendments will be as follows:

(a) substantial reduction in the external accounting controls of legal entities so that the calculation of the accounting income will be as near as possible to that of fiscal income. The reduction of these controls will make it possible to eliminate a vast amount of paperwork and forms while simplifying those that remain;
(b) increasing the ceiling on the taxation of legal entities based on presumed income to make it possible for more taxpayers to avoid the bureaucratic tangles that they face when taxed on the basis of real income. This measure will benefit the vast majority of small and medium-sized businesses which are one of the economic agents now responsible for the greatest level of absorption of manpower;

[continued on page 382]

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BRAZIL:

Taxation Agreements under the New Constitution

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I. THE NEW BRAZILIAN CONSTITUTION (1988)

On 5 October 1988 Brazil adopted a new Constitution (BFC) which was the subject of much redrafting following copious discussions, considerable pressure from the media and intense lobbying on behalf of most sectors of Brazilian society. The new Constitution comprises 315 provisions, 18 of which are contained in the Brazilian Tax System Chapter (BFC Arts. 145-162). In addition to the Tax System Chapter, one additional article concerns special social security contributions and several others, directly or indirectly, have a bearing on taxation and the tax statutes to be enacted by the 3 separate taxing powers, i.e. the States, the Municipalities and the Federal District.

II. BRAZILIAN REALITY

The Roman dictum "ex facto jus oritur" may be aptly used when discussing taxation law, since taxation powers and their distribution among taxing entities as well as fiscal policy and objectives are conditioned by the facts of Brazil's situation.

Knowledge of these facts, or, what one might call Brazilian reality, is of utmost relevance to the understanding of the constitutional principles underlying the Brazilian tax law. These principles are the subject of a detailed study elsewhere in this issue of the *Bulletin* and govern all double taxation agreements into which Brazil has entered or will enter in the future.

A. Geographical Brazil

Brazil ranks fourth among the countries of the world in terms of land area (8,551,965 square km) and is inhabited by nearly 145 million people. It is a rapidly growing country as can be seen by comparing the 40 million inhabitants accounted for in the 1940 census to the 120 million people in the 1980 census. (Censuses are conducted every 10 years.) During 1940-1980 the population moved from the rural areas to the cities, resulting in a dramatic change in the ratio of those inhabiting rural areas to those inhabiting city areas – from 20:80 in 1940 to 80:20 in the present day.

This rapid urbanization and the fact that railroads account for only a small part of the traffic between cities, giving rise to a tremendous oil bill – 1 million barrels per day are imported – have contributed to Brazil's position as the nation with the highest external debt (nearly US$ 130 billion).[1] Other contributory factors include the need for heavy investment in the energy, health, social and educational sectors.

B. Administrative division

Divided today into 26 States, plus 1 Federal District (Brasilia), Brazil had in 1985 4,442 Municipalities, of which 386 comprised more than 50,000 inhabitants, 177 more than 100,000 inhabitants, 20 more than 500,000 and 10 more than 1 million inhabitants.

As Brazil is a young country, with nearly 50% of its population under 20 years old and a high (2.4%) annual population increase, the need to provide employment and create a job market dictates a good part of fiscal political decisions.

C. A peculiar federation

Brazil is a federative republic. It is, however, a very peculiar federation, since its federated parties are the States, the Municipalities and the Federal District (BFC – Art. 1° "caput"), each party enjoying full autonomy under the terms of the Constitution (BFC – Art. 18° "caput").

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1. This is despite a successful shift to alcohol-powered cars – 90% of Brazilian cars are alcohol-powered – and a significant increase in local oil production.

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III. THE BRAZILIAN CONSTITUTION AND INTERNATIONAL RELATIONSHIP PRINCIPLES

A. International relationship principles within the Constitution

According to Art. 4 of the new Constitution (BFC), Brazil's international relationships are to be governed by the following principles:

I – national independence;
II – the pre-eminence of human rights;
III – the right to self-determination;
IV – non-intervention;
V – equality among the States;
VI – the defense of peace;
VII – peaceful solution of conflicts;
VIII – repudiation of terrorism and racism;
IX – cooperation among nations for the progress of mankind;
X – granting of political asylum.

The Federative Republic of Brazil is to work towards the economic, political, social and cultural integration of the peoples of Latin America, in order to form a Latin American community of nations.

B. The making of an international treaty

All international treaties must be signed by the President of the Republic.[2] Once signed by the President, international treaties must be submitted to the Federal Congress, which is alone qualified: "to resolve conclusively on international acts, agreements or treaties which involve charges or commitments against the national patrimony" (BFC Art. 49, I).

C. Sovereignty of the Union

A preliminary remark needs to be made regarding international treaties, and double taxation agreements specifically.

Since Brazil is a Federative Republic, the Federal Union (the Union) possesses sovereignty, whereas the States, the Municipalities and the Federal District possess only autonomy.

This means that only the Union may enter into any kind of international agreement since international agreements require sovereign States as parties. However, the Union has to conform, whenever entering into an international agreement of any kind, to the provisions of the BFC concerning among other things the autonomy granted to the States, the Municipalities and the Federal District and the taxation powers attributed to each of them.

As this study progresses we shall refer to the problems which are likely to arise in this connection.

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2. To the President belongs the exclusive right "to enter into international treaties, conventions and acts, subject to the approval of Congress" (BFC Art. 84, VIII).

IV. FUNDAMENTAL INDIVIDUAL AND COLLECTIVE RIGHTS AND GUARANTEES WITHIN THE CONSTITUTION

A. Fundamental rights which may concern the provisions of double taxation agreements

Fundamental rights and guarantees are extensively listed in the 77 items of Art. 5 of the BFC, although paragraph 2° of this Article states that:

> The rights and guarantees established in this Constitution do not preclude others arising out of the regime and the principles adopted by it, or out of international treaties to which the Federative Republic of Brazil is a party.

Of these rights it is important to mention, because of their relevance to the provisions of double taxation agreements, the legality principle:
"no one shall be obliged to do or not to do something except by virtue of a law." (BFC Art. 5, II);
the right to privacy:
"the secrecy of correspondence and of telegraphic, data and telephone communications is inviolable, except, in the latter case, by court order, in the circumstances and in the manner established by the law for the purposes of criminal investigation or criminal procedural discovery." (BFC Art. 5, XII);
intellectual property rights:
"authors have exclusive rights to use, publish or reproduce their works, and such rights may be conveyed to their heirs for the period which the law may establish". (BFC Art. 5, XXVII);
"under the terms of the law, the following is ensured:
a) protection of individual participation in collective works and of reproduction of the human voice and image, including with regard to sports activities;
b) the right of authors, performers and respective trade unions and associations to monitor the economic exploitation of the works which they create or in which they participate." (BFC Art. 5, XXVIII);
"the law shall assure the authors of industrial inventions of a temporary privilege for their use, as well as protection of industrial creations, of ownership of trade marks, of company names and of other distinctive symbols, with due regard for social interests and for the technological and economic development of Brazil." (BFC Art. 5, XXIX);
the right to inherit:
"the right to inheritance is guaranteed." (BFC Art. 5, XXX);
"succession to assets owned by foreigners and located in Brazil shall be governed by Brazilian law, in favor of the Brazilian spouse or children, whenever the personal law of the deceased is not more favorable to them". (BFC Art. 5, XXXI);
the right to a judgment from the judiciary power, so that every decision of the Administration is subject to judiciary control:
"the law shall not exclude from review by the Judiciary any violation of or threat to a right." (BFC Art. 5, XXXV);
as well as the right expressed in item XXXVI:
"the law shall not impair a vested right, a perfect

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juridical act or "res judicata"." (BFC Art. 5, XXXVI); and the right to due process of law:
"no one shall be deprived of his or her freedom or assets without due process of law." (BFC Art. 5, LIV).

B. Fundamental guarantees

All these rights are the subject of guarantees which the judiciary power is entitled to grant, namely: habeas corpus (BFC Art. 5, LXVIII), "mandado de segurança", a "writ" which is akin to a number of Anglo-Saxon writs and that of the Mexican "juicio de amparo" (BFC Art. 5, LXIX and LXX), "mandado de injunção" a "writ" to be used whenever the lack of an appropriate statute renders a constitutional right ineffectual (BFC Art. 5, LXXI), "habeas data", a "writ" to safeguard the citizen's right to know whatever information about him is registered in governmental records (BFC Art. 5, LXXII) as well as the right to petition and the right to obtain written certificates from the Public Authority (BFC Art. 5, XXXIV "a" and "b").

V. THE DIFFERENT TAXES

As mentioned above there are 3 different taxing powers. The different taxes which each taxing power is entitled to levy may be the subject of a double taxation agreement and yet lie outside the powers of the Union. Special reference has, therefore, to be made to the taxes which it is incumbent on the States to levy, in accordance with BFC Art. 155, these being
"taxes on:
a) transfer by death and donation of any property or rights;
b) transactions relating to circulation of goods, and the rendering of services of interstate and intermunicipal transportation, and of communication services, even if the transactions and rendering begin abroad;
c) ownership of automotive vehicles;
additional tax of up to 5% of the tax paid to the Republic by individuals or legal entities domiciled in the respective territories, by way of the tax set forth in Art. 153, III, on capital profits, gains and income." (BFC Art. 155, I and II).

As far as the municipalities are concerned the most important tax which may give rise to international taxation problems is the tax referred to in BFC Art. 156, II on: "transfer 'inter vivos', on any account and for consideration, of real property by natural or physical accession and of any in rem rights to real property, except for collateral, as well as the assignment of rights to the purchase thereof;" which according to para. 2, II, is attributable to the Municipality where the property is located.

Besides these provisions, Sec. VI of the Taxation System Chapter sets forth an apportionment of tributary revenues, where percentages of Union taxes on income and earnings of any nature and on non-manufactured products are allocated to a Participation Fund of the States and a Participation Fund of the Municipalities (BFC Art. 159, I).

It is also a well-known fact in Brazil that States and Municipalities are increasingly challenging the central power – the Union – and are daily more zealously protective of their sources of funds.

VI. THE 180 DEGREE SHIFT IN THE POWER OF THE UNION TO GRANT EXEMPTIONS

Under the previous Constitution, the Union could grant exemption from State and Municipal taxes (Art. 19, para. 2) provided certain conditions were met and a supplemental law was enacted.

Reflecting the rebellion against what has been called "excessive concentration of powers in the hands of the central power (the Union)", the new BFC completely changed the approach to this issue, so that the Union is now forbidden: "to institute exemptions from taxes within the jurisdiction of the States, the Federal District or the Municipalities" (BFC Art. 151, III).

VII. THE INTERNATIONAL CONSEQUENCES

Since the Union can no longer grant exemptions from State and Municipal taxes, many double taxation agreements will undoubtedly become the focus of disputes between States or Municipalities and the Union, with consequences both for the double taxation agreements already in force, and the position of the Union in future tax treaty negotiations.

A. Double taxation agreements on income and on capital

A prime target is likely to be the double taxation agreements already in force, which deal with the Brazilian federal income tax, usually included in Art. 2 under "taxes covered", in accordance with the OECD and U.N. Models.

Indeed, as States are now entitled to institute an additional tax of up to 5% of the tax paid to the Union on capital profits, gains and income (BFC Art. 155, II), any double taxation agreement which limits the taxation of dividends, interest or capital gains may be claimed by any individual Brazilian State to be in contravention of the BFC, on the grounds that such an agreement will reduce its financial resources. Arts. 10, 11 and 13 of the Brazil–Germany agreement and Arts. 10, 11 and 13 of the Brazil–Argentina agreement exemplify the problem.

The Articles concerning shipping, transport on inland waterways and air transport (OECD and U.N. Model Art. 8) may also be selected as a target by the States, since they are empowered to collect the additional tax on payments made by individuals or legal entities domiciled in their respective territories.

It goes without saying that even the fiscal domicile provision might be endangered (OECD and U.N.

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Model Art. 4 – Resident) if a State were to challenge the power of the Union to accept in a double taxation agreement a definition that would deprive it of part of its revenues.

B. General Agreement on Tariffs and Trade (GATT)

The provisions of the GATT (mainly those in Part II, Art. III – "National Treatment of Internal Taxation and Regulation"), such as the equal fiscal treatment of imported products (Art. III.2), the provision on "treatment no less favorable than that accorded to like products of national origin" (Art. III.4) and the general most-favored-nation treatment (Part I Art. I.1.) may also be challenged by the Brazilian Federated States, because they represent an invasion, by the Union which concluded the agreement, of their autonomy with respect to their taxing power.

C. Double taxation agreements on estates and inheritance

It belongs to the Federated States and to the Federal District to institute taxes on: "transfer by death and donation of any property or right" (BFC Art. 155, I, "a").

Furthermore the BFC contains rules concerning cases where the deceased property owner was resident or domiciled abroad or had his or her probate processed abroad (BFC Art. 155, para. 1, III, "b") and also where the donor is domiciled or resident abroad (BFC Art. 155, para. 1, III, "a"). Given these facts, double taxation agreements on this subject may well present a problem.

In this particular instance, the BFC provides for a supplemental law, a statute which is complementary to the BFC and is ranked above ordinary statutes, so that Federated States must abide by it.

VIII. SOLUTION OF THE CONFLICTS

Unfortunately, the conflicts will not be between States and the Union, but between States and taxpayers.

Taxpayers may bring their cases to the courts, since access to the judiciary is a fundamental right which can be invoked either by an individual or an entity (BFC Art. 5, XXXV) through one of the constitutional remedies (guarantees), principally the "mandado de segurança", which can be used in a preventive way to avoid a fiscal action, or through a normal action declaring an act of the Union, State or Municipality unconstitutional.

IX. AUTONOMY AND SOVEREIGNTY

The author believes that if a distinction is made by the courts between sovereignty and autonomy in their interpretation of BFC, this will prevent a large number of cases from coming to fruition.

Justice J.F. Rezek, member of the Brazilian Supreme Court (Supremo Tribunal Federal), provides the answer when he reports Alexander Hamilton's discussions with Thomas Jefferson when the foundations of federation were being laid in the United States. Jefferson deemed it possible to have a double degree of sovereignty within the federation, whereas Hamilton defended the idea that Federated States are autonomous members of a sole sovereignty. The judge's answer is that Federated States, precisely because they are Federated, have no public personality in international law and therefore have no legal qualification to express their will or to be actors on the international stage.[3]

This approach is the key to the solution of the problems which may arise. Only the sovereign State of Brazil has rights and duties before other nations – none of its Federated States or Municipalities are able to interfere or intervene in international relations.

The new Constitution supports this conclusion in the following ways:

(a) It is the Federative Republic of Brazil, formed, according to BFC Art. 1, by the indissoluble union of States, Municipalities and Federal District, that is declared, in the same article, to be founded on sovereignty and not the States, the Municipalities, or the Federal District.
(b) International relationships, referred to in Art. 4, are designated to the Federative Republic of Brazil, not to federated entities of any kind.
(c) It is a duty of the President of the Republic:
"to maintain relations with foreign States and to accredit their diplomatic representatives" (BFC Art. 84, VII),
as well as:
"to enter into international treaties, conventions and acts, with the approval of Congress" (BFC Art. 84, VIII).

In representing a Republic, which is a Federative Republic, the President also represents all the States.

Finally, it must also be remembered that when an international treaty is entered into, the matter must be referred to Congress.

Unlike the United States, where only the approval of the Senate is necessary, Congress, which means both Senate (Senado) and House of Representatives (Câmara dos Deputados), has to approve any treaty entered into by the President.

The dual chamber system, in Brazil, exists to ensure the equal representation of the States at the Senate, which is composed of members who represent the States and the Federal District, elected by majority vote. Each State and the Federal District, regardless of their population, are represented by 3 senators (BFC Art. 46).

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3. Direito Internacional Público, Ed Saraiva – SP, 1.984 – page 337, No. 143.

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The population, under the proportional system, elects the members of the House of Representatives (BFC Art. 45).

Under this system it can, therefore, be said that the Federated States are represented at the Senate and that the Municipalities are represented at the House of Representatives.

However, attempts to challenge the central power are inevitable as individual States try to obtain a fatter share of the total tax revenue.

The Brazilian Supreme Court, whose role as protector of the Constitution was enhanced by the new BFC, will establish the exact limits of autonomy as far as international tax law is concerned.

Conference Diary

AUGUST 1989

45th Congress International Institute of Public Finance, on Public Finance and Steady Economic Growth. Buenos Aires, 28-31 August (English):
International Institute of Public Finance, General Secretariat, University of Saarland, D-6600 Saarbrücken 11, West Germany.

SEPTEMBER 1989

Joint Seminar of the U.S. and British Branches of I.F.A. prior to the RIO Congress. Coral Gables. Miami, 7-8 September (English):
Subject I: Acquisitions and Dispositions across International Frontiers.
Subject II: Major Tax Issues in Cross Border U.S./U.K. Investments.
Subject III: Intercompany Dealings and the U.S. White Paper.
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

I.T.P.A. Workshop. Monte-Carlo, 14-15 September (English):
To: Elisabeth Walters, Conference Director, International Tax Planning Association, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

43rd IFA Congress: Rio de Janeiro, Brazil, 10-15 September 1989.
Subject I: Disregarding a Legal Entity for Tax Purposes.
Subject II: Administrative and Compliance Costs of Taxation.
Seminar A: Taxation of Services as Rendered Internationally as Opposed to Technical Assistance or Industrial Licence Agreements.
Seminar B: Tax Treaties and Domestic Legislation.
Seminar C: Turnkey Jobs.
Seminar D: Taxation Systems of the South American Common Market.
International Fiscal Association, World Trade Centre, P.O. Box 30215, 3001 DE Rotterdam.

Fundamental Elements of U.S. Federal Taxation; U.S. / International Taxation; U.S. Individual / Expatriate Taxation. Lésigny, 18-23 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London, W1M 5FT, United Kingdom.

U.S. Capital Market Instruments, Innovative and Tax-effective. Zürich (Switzerland), 27 September (English).
Swiss-American Chamber of Commerce, Talacker 41, CH-8001 Zürich, Switzerland.

Praktiker-Seminar zur Steuerreform 1990. Wiesbaden, 22 September; Stuttgart, 23 September; München, 29 September; Würzburg, 30 September (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

OCTOBER 1989

IBFD-MIEM (Bocconi University) Seminar on Corporate Tax Strategy in Europe and the United States and Intercompany Pricing. Milan, 26-27 October (English):
International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

NOVEMBER 1989

Leasing; Innovative Financing; Tax Advantages. Brussels, 6-9 November (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

Fiscale Harmonisatie en de Gevolgen daarvan voor Nederland. Rotterdam, 7 November (Dutch):
Nederlands Studie Centrum, Antwoordnummer 350, 3130 VB Vlaardingen, The Netherlands.

The 12th Annual Congress of the American Tax Institute in Europe: New Developments in U.S.-European Taxation. Cannes, 13-15 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

I.T.P.A. Seminar. Palm Beach, 20-21 November (English):
Ms. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, United Kingdom.

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

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The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, U.K. Telephone (1) 935 7502, telefax (1) 935 1308.

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Management Centre Europe, rue Caroly 15, B-1040 Brussels (Belgium).

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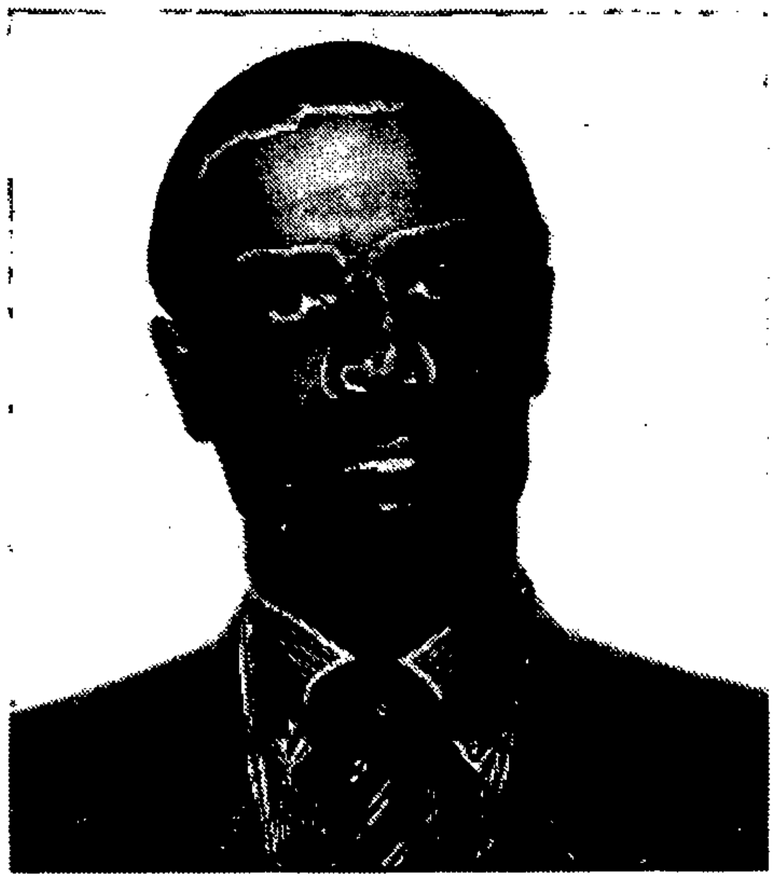
Brazilian Tax Treatment of Foreign Investments

Luiz Fernando Teixeira Pinto



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I. INTRODUCTION

A general picture of the Brazilian tax treatment of foreign investments requires knowledge of how an investment can be made in Brazil. It is therefore necessary to draw a distinction between typical foreign investments, i.e. investments made by an individual or company domiciled abroad and investments made by a foreign individual who is a permanent resident of Brazil but not a naturalized Brazilian. The second type of investment is considered a domestic investment. The former is the subject of specific regulations and will be discussed in the following paragraphs.

The basic legal framework for foreign investments in Brazil is contained in Law 4131, enacted in 1962 and amended by Law 4390 of 1964, which guarantees that foreign capital invested in Brazil will be treated as if it were domestic capital. As a result of the economic growth Brazil has experienced over the last 25 years, the legislative framework has necessarily been supplemented by a large number of administrative regulations issued by the competent Government departments.

Foreign investments are subject to registration with the Central Bank of Brazil which issues a certificate of registration showing the amount of the foreign investment.[1] This certificate is the basis for remittance of dividends and reinvestment of profits, or for repatriation of capital, as well as for the assessment of supplementary income tax.

The original registration of a foreign investment with the Central Bank will be made in the currency actually entering Brazil. Any remittance of profits thereafter will be made, or any reinvestment of profits registered, in the currency of the country where the investor is resident or established.

The prior approval of the Brazilian authorities is not required for a foreign investment in currency. Such a transaction is generally accomplished through the formation of a new company, in which case capital will be subscribed to and paid up with the proceeds of the investment or through the acquisition of all or part of the capital of an already existing Brazilian company. All the investor is required to do is remit the money to Brazil through a bank authorized to deal in foreign exchange. The Brazilian company receiving the investment will then apply to the Central Bank of Brazil for registration of the investment in the currency actually entering Brazil.

Brazilian law also contemplates the possibility of foreign investment by the importation of goods, machinery or equipment without exchange cover. This kind of investment, however, must be submitted for prior approval by the Central Bank of Brazil and CACEX (Foreign Trade Department of Banco do Brasil). The equipment to be imported must be designed for the production of goods or the rendering of services and may not have a Brazilian counterpart. It must be used in projects of interest to the economic development of Brazil. The importation of used equipment may be permitted, although, in principle, this practice is not well regarded by the Brazilian authorities and they may create difficulties. After obtaining the requisite authorization, the Brazilian company must obtain the necessary import licenses and arrange for shipment of the goods. Within 30 days after the goods have cleared Customs, the corresponding values must be capitalized and application for registration of the respective investment must be submitted to the Central Bank. The Central Bank will register the investment in the currency of the investor's country. The recipient company is required to keep the equipment as part of its fixed assets for at least 5 years. The importation of equipment is subject to import duties and other customs charges.

Credit, such as foreign loans or fees for technical assistance under an agreement registered with the National Institute of Industrial Property (INPI) and the Central Bank of Brazil, can also be capitalized and converted into foreign investment. This conversion requires the prior authorization of the Central Bank as well as compliance with a series of formalities. After Central Bank authorization has been granted, the Brazilian

1. For the requirements to be fulfilled in order to register foreign capital investments with the Central Bank, see in this issue, Arthur Andersen, "Guide to Taxation, Trade and Investment", at 355.

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company must carry out a "symbolic exchange transaction" – the closing of an exchange contract providing for the sale and purchase of the foreign currency owned by the foreign creditor-investor. The Brazilian company must capitalize the funds within 30 days of authorization and subsequently apply for registration of the investment with the Central Bank, which will register the investment in the currency of the converted credits.

The profits earned by the Brazilian company may either be reinvested in the company itself by capitalization or distributed to the stockholders as dividends. If the stockholders decide that the profits are to be reinvested in the company, new quotas or shares will be issued to the foreign investor in proportion to the number of quotas or shares already held. These new quotas or shares should be registered with the Central Bank of Brazil in the name of the foreign investor as a foreign currency reinvestment, thereby increasing the basis of calculation for future remittance of profits abroad for tax purposes.

As a general rule, the Central Bank of Brazil only registers as reinvestments profits that result from the Brazilian company's actual operations. It is thus important to note that if profits from financial investments represent more than 50% of the company's total income for 2 consecutive financial years, they are not eligible for registration as reinvestments.

The policy is also restrictive in the case of companies capitalizing profits earned from the rendering of services. In general, this policy requires the submission of evidence by the Brazilian company to the Central Bank of Brazil that the service agreement has been registered with INPI when it refers to technical services. If, however, the subject matter of the agreement does not require registration with INPI, the company must prove this fact to the Central Bank of Brazil.

Profit capitalization is not subject to any tax unless the company's capital has been reduced during the previous 5 years or the company is liquidated during the 5 years following capitalization.

II. RESTRICTIONS ON FOREIGN INVESTMENTS

Although foreign capital is generally afforded the same treatment given to Brazilian capital, there are restrictions as to the activities that foreign investors may engage in.

The new Brazilian Constitution established a clear distinction between Brazilian companies and Brazilian companies with domestic capital. Brazilian companies are considered to be those incorporated under Brazilian law with their principal place of business and management in Brazil. Brazilian companies with domestic capital are those companies whose actual control is permanently held, directly or indirectly, by individuals resident and domiciled in Brazil or by public domestic law entities. Actual control of a company is defined as the ownership of the majority of the voting capital or de facto exercise of the decision-making power to manage the activities of the company.

The Constitution also provides that the law may: (i) grant protection and benefits to Brazilian companies with domestic capital on a temporary basis for the development of activities considered essential for the development of the country or strategic for national defence purposes; and (ii) establish conditions for activities considered essential for the development of domestic technology.

With regard to the purchase of goods and services, the Government shall grant preferred treatment to Brazilian companies with domestic capital. The law shall establish rules based on the concept of preferred treatment which will be given to Brazilian companies with domestic capital in such transactions. Before the new Constitution was enacted, companies which contracted with the Government to render technical assistance or to execute engineering services had to be controlled by Brazilian citizens.

III. STRUCTURE OF THE LEGAL SYSTEM OF TAXATION OF FOREIGN INVESTMENTS

The Brazilian structure of taxation of non-residents is based on the practice of collecting withholding tax. It originates the phenomenon of indirect or "passive" tax liability (in its tax substitution aspect), since the actual paying source of the income or revenue earned by the non-resident is responsible for (a) determining whether or not the income or revenue is subject to tax; (b) calculating the tax; (c) withholding the tax; and (d) paying the tax to the revenue authorities.

By the very nature of such responsibility, it is clear that the paying source could be considered to be the actual passive person who is liable to pay income tax assessed on income or revenue earned by a non-resident and derived from a foreign investment. In this context, the paying source is regarded as a substitute taxpayer accounting for its own liability, i.e. liability for failure to withhold and payment of the tax is not attributed to the beneficiary of the income or revenue (i.e. the foreign investor). Income tax legislation in fact provides that although the paying source is not the taxpayer, the paying source is liable for payment of the tax even if it has not withheld the tax.

Withholding tax at source offers several advantages as far as the tax authorities are concerned:

(a) ease and convenience in collection and control, since in the event it is impossible to reach the resident abroad the entire tax burden falls on the paying source;
(b) simplicity and greater efficiency in administering collection, which are consequences of focusing on the passive taxpayer;
(c) prevention of non-payment, fraud and other forms of tax evasion because the paying source situated in Brazil is responsible for the tax liability as regards calculation, withholding (by deduction) and payment of the tax due by the non-resident;[2]
(d) reducing the scaled earning of income and expedit-

2. This is the sole liability of the paying source and is not transferrable to the beneficiary.

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ing receipts, in view of the fact that upon legal or economic availability (payment, credit, delivery, use or remittance) of funds to a non-resident,[3] withholding is compulsory.

IV. SCOPE OF TAXATION OF FOREIGN INVESTMENTS

As mentioned above, as regards income obtained by residents abroad, Brazilian law has adopted the principle of a withholding tax on income for the purpose of levying income tax. This provision has nevertheless been the subject of judicial discussion when the source of the payment does not coincide with the production source (Brazil) of the income.

It must be emphasized that there is no provision in Brazil for a tax on capital, and that income tax law, as regards non-residents, makes no distinction between "income" and "capital gains" for purposes of assessment. Brazilian tax law provides that, in general, income and capital gains obtained by non-residents are taxed at the rate of 25%, including income earned on short-term transactions and capital gains relating to foreign investments.

Dividends and profits relating to foreign investments distributed to non-residents are also subject to supplementary income tax whenever the yearly average distributed in one 3-year period exceeds 12% of the capital and reinvestments registered with the Central Bank. The supplementary tax will not be levied, however, if the profits and dividends are reinvested in the same companies from which they proceeded or in another sector of the domestic economy.

The following scale should be followed in calculating this supplementary income tax:

Profit on capital and reinvestment	*Rate*
– between 12% and 15%	40%
– between 15% and 25%	50%
– over 25%	60%

Profits distributed to non-residents which are derived from investments in activities considered of lesser interest to the domestic economy will be subject to an increase in withholding tax equivalent to 20%.

The general rate of 25% is reduced if a tax treaty exists. Brazil has signed and ratified double taxation treaties with more than 15 countries. The treaties already ratified by Brazil deal exclusively with income tax, and the principal classes of income covered are profits or dividends, interest, royalties, capital gains, company profits, directors' compensation, rents from real property, remuneration of salaried or self-employed workers and certain professionals (e.g. teachers, entertainers, artists, etc.).

Brazil's double taxation treaties establish that dividends should be taxed in the country of the recipient but may also be taxed in Brazil. The maximum rates for Brazilian tax could be reduced by treaty depending on the country, to 15%.[4]

Although the general rule of the 25% withholding tax rate established for dividends received by non-residents has not been changed in the last few years, the method for determining how the profits of a Brazilian company would be taxed has changed significantly. In the last few days of December 1988, the Brazilian Congress enacted new income tax regulations (Law 7713) which considerably changed the tax treatment to which Brazilian companies were subject. As from January 1989, corporate income tax has been reduced to 30% (previously 35%). The rates on which the supplementary corporate income tax and its percentage were calculated have also been altered. The new legislation also provided for the establishment of a "social contribution" of 8% calculated on the results of the corporate financial year, which is considered a deductible expense for the Brazilian company.

Law 7713 has also created a new taxable event, i.e. an 8% income tax rate assessed on the net profit shown after deduction of corporate income tax. This new assessment is made regardless of whether or not there is a dividend distribution, and the tax is due even in the case of profit capitalization.

If the Brazilian company decides to distribute dividends in accordance with Law 7713, no further tax will be due. This means that the quotaholders or shareholders of a Brazilian company which had its profits taxed as above will be exempt from payment of any additional tax when the profits are distributed. This provision is not applicable when the profits are distributed, via dividends, to quotaholders or shareholders resident abroad; in such case the 8% tax will be used as tax credit when the 25% withholding tax is assessed.

This situation, which seems normal and correct when focused from the general point of view of a non-resident, could be interpreted differently if one considers the existence of Brazil's double taxation treaties. The Brazilian tax treaties, which follow basically the OECD Model, contain the "non-discrimination clause", establishing that "nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances are or may be subjected". In other words, this clause ensures that the tax treatment accorded to individuals and companies resident in Brazil shall be the same as that given to individuals and companies resident in a country with which Brazil has signed a treaty to avoid double taxation.

As a corollary of what has been stated above, the tax exemption granted on profits distributed to Brazilian residents should also be extended to those profits distributed to individuals or companies resident in countries with which Brazil has double taxation treaties, as imposed by the "non-discrimination clause".

It should be noted that the Brazilian Tax Code establishes that international treaties and conventions override both current and future tax legislation.

3. Art. 575, IV of the Income Tax Regulations.
4. The tax is reduced to 12.5% in the treaty with Japan.

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BRAZIL:

The Constitutional Tax Reform 1988

An Overview

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On 15 November 1889 Brazil was declared a Federative Republic. For 67 years, it had been an independent nation of a unitarian structure ruled by a constitutional Emperor. With the adoption of the federative form of government a number of problems arose. In point of taxing powers, the unitarian government was changed to a hybrid system under which the Union, the states and the municipalities were all granted taxing powers. Unlike other federations, Brazil vests local authorities with competence to institute taxes. Consequently, political entities of all 3 levels of government derive their power to institute and collect taxes from the same source, i.e. the Federal Constitution.

The first Republican Constitution of Brazil was promulgated on 24 February 1891. It drew its main directives from the U.S. Constitution, although it retained a number of aspects of a legal system derived from Roman continental law, which Brazil had adopted since its independence. One such characteristic was and still is that Brazil's legal structure is based primarily on statute and its rules take always strictly defined subjective individual rights through laws rather than through broadly defined legal standards as is the case in the United States and other equity or common law jurisdictions.

The sharing of taxing power among the Federal Union, the states and municipalities has been the subject of strict constitutional competence; as time passed and new Constitutions were promulgated after the advent of the Republic, the rigidness of the competence of each of the 3 political entities became stricter. In 1965 a major tax reform was introduced whereby the Brazilian tax system was reorganized and given a more rational structure. Complementary laws were introduced under which the National Congress could implement the Constitution; the laws were binding upon the Union, the states and the municipalities. The constitutional provisions could be effectuated by acts of the National Congress to the extent necessary to implement, but not change or expand, the Constitution itself.

Complementary legislation aroused a great deal of criticism. Some authors argued that the legislation deviated from the principle of federalism and the independence and autonomy of the states and municipalities. However, both court decisions and a majority of legal writers favored complementary laws which were limited to implementing points dealt with in the Constitution or which established general principles of tax law binding on the Federal Union, the states and the municipalities.

The tax system established in 1965 comprised taxes, rates and betterment levies. Taxes (impostos) were defined as public revenue in the nature of compulsory payments collected by the Government to provide funds necessary for the discharge of general public services. Rates (taxas) were defined as taxes collected as the counterpart to specific and divisible services actually rendered to the taxpayers or made available to them, or as the instrument of the exercise of police power. As to the betterment levy, it hardly shares the real nature of a tax for it is meant to cover the cost of public works that increase the value of real estate and is limited to the benefit each of its payors derive from the works.

Federal taxes included income tax, import and export duties, non-cumulative excise tax, tax on financial, insurance and exchange operations and sales of securities, a tax on oil and its by-products, electrical energy and domestic minerals (a tax that was assessed only once on each product and which was known as "single tax"), and a tax on transportation and communications. State taxes included a value added tax on the circulation of goods (the states' main tax), a tax on the ownership of motor vehicles and a tax on the transfer of real estate. The municipalities were allowed to collect a services tax (except on services subject to Federal or state taxing power) and a tax on urban real estate. The Federal Union, the states and the municipalities could levy rates and betterment levies with respect to their services and public works.

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Since Brazil is a very large country with social and economic imbalance between developed and very poor regions, the Constitutional tax reform of 1965 instituted a system of sharing in the Federal Union and the states' tax revenue in favor of the states and the municipalities, respectively. Under this system, a share of the federal taxes collected throughout the country would be delivered to the states and municipalities according to certain indexes. The indexes consist of a percentage which increased as the per capita income decreased and the extension of the area and the population of the states and municipalities increased. The participation in Federal taxes by the states and municipalities was computed on the proceeds from Federal income and excise taxes and on the Federal single tax on oil, energy and domestic minerals. The municipalities also shared in the state income from the tax on circulation of goods and in the Federal single taxes.

Political changes resulting from Brazil's return to its traditional democratic situation in 1984 with the election of a civilian as President, caused a reaction against the strong Central Government and the bid for an expanded State and more strength and power for the municipalities. The Federal Constitution promulgated on 5 October 1988 reorganized the tax system with the main purpose of granting to the regional and local organs a better share in taxing power. The new Constitution weakened the Federal Union not only because some of its former taxes were abolished or turned over to the states and/or municipalities, but also because the rates of the shares of Federal taxes to be assigned to the states and municipalities were considerably increased.

Although decentralization in itself is no evil, it is my view that the Constitution failed to reduce the burden and the incumbencies of the Union in proportion to the reduction of Federal tax revenue, thus causing the Union to have to increase the weight of its remaining taxes, thereby heavily penalizing the taxpayers at large.

Since the 1965 tax reform, the power to tax foreign trade has been the province of the Union, as is normal in all countries. Prior to the reform, taxes on imports were Federal, while taxes on exports belonged to the states. Thereafter export tax became Federal, so the Union could adopt a fiscal policy consistent with its power to control international commercial relationships.

Taxes on the production and circulation of goods and services are allocated to the competence of the 3 levels of government. The Union is empowered to levy excise taxes (a kind of value added taxation), which unlike in other countries, has an ample field of incidence rather than being a tax on luxury goods. For a long time, excise taxes had been the main source of Federal tax revenue, seconded by income tax, but now excise tax is in second place. It is levied only on manufactured goods and its taxable event is the shipment of manufactured goods from a factory or their clearance from customs when imported. As in most other countries, excise taxes in Brazil do not fall on the shipment of manufactured goods to foreign markets.

The states are entitled to collect a tax on the circulation of goods and some services. This is also a non-cumulative tax and both the Constitution and complementary legislation have provided thereon in detail to ensure that each state will abide by a set of rigidly established norms so that the tax may be levied and collected in each state in accordance with uniform principles. The tax, in fact, has the nature of a natural tax, owing to its non-cumulative nature. The amount of tax paid in previous shipments may be credited against the amount of tax falling on each subsequent shipment, including cases of inter-state trade.

Like the Federal excise tax, the state tax on circulation does not fall on shipments of manufactured goods sent abroad so the burden of domestic taxes is not transferred to non-resident buyers. Under the current Constitution, the rates of tax on the circulation of goods may vary with respect to the degree of essentiality of each product.

Before the promulgation of the 1988 Constitution the state tax on circulation was assessable only on goods. It is well known that the TVA or IVA (value added taxes) as they are known and levied in Europe encompass not only the value of goods but also the services, energy, machinery and equipment used to manufacture goods. The Constitution now in force allows transportation services which are not strictly local and communications to be included in the tax on circulation.

The expansion of the field of taxing power in favor of the states was gained at the expense of the Federal Union, for the tax on interstate or inter-municipal transportation and communications belonged to the Union under the previous Constitution. One could presume that the switch of taxing power was intended to provide the states with competence to levy tax not only on the value of goods but also on the amount of services and use of equipment and machinery employed in the manufacture of goods. In fact, this could hardly have been the reason for the transfer of the taxes on transportation and communications to the states, for such services are not, or at least not in all cases, related to the production of goods (as would be the case, for example, with reference to transportation of the shipped goods, which is normally a part of the selling price). In fact, this would never be the case with transportation of persons or with communications.

The municipalities are empowered to levy taxes on the rendering of services of whatever kind which are not under the competence of the states or the Union. The scope of incidence of the tax is very broad for it covers professional, commercial and industrial services. In order to avoid having service tax assimilated to individual income tax, the tax on services rendered by members of the professions whose activities are governed by specific laws (lawyers, accountants, medical doctors, economists and others) individually or by firms must not be assessed on the price charged for the service.

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The Union has the power to institute and collect a tax on credit, foreign exchange, insurance transactions and transactions involving the disposal of securities. It is a Federal tax consistent with the fact that only the Union is competent to enact laws and exercise control over banking, insurance and stock trading.

Income tax was reserved for the Union until the promulgation of the current Constitution which allows the states to institute a tax on capital income and gains as a percentage of the Federal tax paid thereon.

The Federal tax on income falls on resident individuals, corporate entities having a presence in Brazil and on income which non-resident individual or corporate entities derive from Brazilian sources. The latter is charged through withholding by the payor, who, although not the actual taxpayer, is still liable to the tax.

The principle of residence or domicile governs when income is taxed to individuals or corporate entities under the base year system. Starting in 1989, individuals became liable to the tax on a pay-as-you-earn (PAYE) basis combined with a withholding at source advance payment. Legal entities that pay salaries, fees, rentals or certain other types of income to individuals must deduct from the income a rate which escalates thus: 0-15-25%. The residence or domicile principle applies to individuals so if an individual lives in or is domiciled in Brazil he must report his worldwide income irrespective of the kind of income or whether it was received in Brazil or abroad. Only non-residents' income or income paid to non-identified payees is subject to tax under the principle of the source of income. The tax is payable if the income is derived from Brazilian sources.

The source principle in Brazil is understood in a way that does not coincide with the concept known in Europe and developed countries. We define the taxing competence by having regard to the economy affected by the *payment* of the income not by the economy that made it possible to supply the goods, services or other utilities. Thus, if a non-resident of Brazil renders services to a Brazilian resident in the United States, under the Brazilian concept of source Brazil would have the power to tax the income paid for the supply of the services insofar as the payment of the income would affect the Brazilian economy, for the payment or credit of the income would require a disbursement in Brazil. The fact that the rendering of the services was made possible in the United States is of no relevance in defining taxing power.

Income tax in Brazil falls on legal entities in general. Only civil partnerships formed by professionals to render services not of a commercial nature (law firms, medical doctors, auditors and other professional firms) are no longer treated as income taxpayers under the current legislation. Unlike individuals, whose income tax under the laws in force is fairly mild (the highest rate is now 25%), corporate entities are subject to high rates, which may in some cases be as high as 50%. Losses can be carried forward under certain conditions.

The Constitution proclaims the principle that taxation of income must be progressive, a tenet of most finance and economics specialists of the Modern Era, but nowadays undergoing heavy fire from some theoricians, mostly in Europe, on account of the planned 1992 unification. Being a question of fiscal policy, I would consider that the Constitution itself should refrain from expressly electing one principle, for it would be more convenient to adopt the more flexible principle of the adequate distribution of public expenses without indicating which one this should be.

This is only one of many instances in which the Convention decided to adopt rules and principles involving the acceptance of tenets that are not of an absolute value but that citizens could endorse. In many situations the Constitution indulged in incorporating rules and principles that merely represent the thought of some ideological or political current as if the mass of Brazilian people held the same opinion on the points ruled. The merits of proportional taxation seem to be out of the question but the same does not hold for progressive taxation.

In fact, most tax policy experts – with special emphasis on the European Economic Community – have held that progressive taxation impairs economic development because it drains too much of the private economy's availabilities to invest and improve commercial relations. Why then write in the Constitution a principle that is undergoing criticism and discussion at the same time the Constitution is being proven?

The Union has been given exclusive powers to institute a tax on "great fortunes" as defined in complementary legislation, which thus far has not been passed. There is much uncertainty among tax specialists as to which criterion should be used to define "great fortunes". Brazil is a large territory with marked differences in development, education and per capita income so a definition of "great fortunes" could not be applicable to the entire country.

The municipalities have the exclusive power to institute and collect taxes on urban real estate. Taxes on property in Brazil have a very discreet tradition. As a general rule, movable assets are not taxed, with the sole exception of motor vehicles, which are subject to taxation by the states.

The power to tax rural land lies exclusively with the Union, so it can be used for extra-fiscal purposes as an instrument to foster and compel the disposition of large tracts of unexplored land and ease the so-called "agrarian reform". Since the policy and execution of the "reform" is vested with the Union, the Constitution allows the Union to institute and collect the tax, although it must pass the proceeds therefrom to the municipalities in whose territories the tax is collected.

The states have the power to collect taxes on inheritances and gifts of any kind. The municipalities are competent to levy taxes on non-gratuitous transfers but only in connection with real estate and the rights to real estate.

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As is well known, after World War I European countries were completely disorganized, families were destroyed, most lost their men and sources of maintenance, not to mention the destruction of houses and even cities, so that what remained of many families could not survive on its own resources. This situation occurred again and in a more serious degree after World War II. Under those unhappy circumstances a new type of compulsory payment to the State was conceived under the name "parafiscal contributions". Reportedly, the first official document in which the word "parafiscalité" was used was the "Inventaire Schumann", submitted in 1948 by the French Minister of Economics, Mr. Robert Schumann, in which he stressed the need to provide for new "taxes" to face the costs of social services, including financial aid and housing for the families that were the victims of World War II.

In spite of its name "parafiscality" and the legal regime which governed said contributions, there has always been concurrence of opinions as to their nature as "taxes" in a broad sense of the word. The main peculiarities of the "parafiscal" contributions were: (a) they should be collected and the resources they generated should be administered in a very decentralized way, so they could serve their purpose more expediently; (b) they should be administered and their proceeds invested exclusively with the purposes of funding social programs instituted to cope with the problems created by the World War for families and collective groups needing assistance.

The 1988 Brazilian Constitution took a firm stand with respect to special (parafiscal) contributions, the institution of which was expressly assigned only to the Union (there is an exception for the institution by the states and municipalities of contributions to fund social assistance to their own public officials). The main question raised many times before courts of law was: should special "parafiscal contributions" be considered a new specimen of taxes in general or should they be given a special status? If the answer were that they belong to the category of taxes in general, all the rules of the Constitution and the National complementary laws (mostly the National Tax Code) applicable to "taxes" in general would govern them as well.

In April 1977, an amendment was made to the 1967 Constitution, to separate from the general category of "taxes" the special parafiscal contributions destined for the funding of social welfare in most of its forms, so they were no longer subject to the general principles on taxation, such as the 5-year statute of limitation to assess and/or collect the contributions. Now all the contributions are treated as taxes in general and subject to the principles that prevail with respect to same. There is one exception. While taxes in general can only be collected in any given year if the law that instituted the law has been passed and published in the "Official Gazette" the year before, a social contribution can be collected 90 days after publication of the law that instituted it.

Since the simple Federal taxes on fuel, energy and domestic minerals have been abolished, the production, industrialization, sale, circulation and exportation of same are now subject to the various Federal, state and municipal taxes falling on each one of said operations. It is foreseen that an increase in the prices of such products cannot be avoided.

The new tax system as a whole entered into full force 1 March 1989. Some of its provisions, however, cannot become effective until complementary legislation is passed.

This article is intended as an overview of the Brazilian tax system for informative purposes only. It is still too early to predict whether the new tax system instituted by the Constitution of 1988 will meet the needs of the Union, the states and the municipalities and favor Brazil's economic growth and development.

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(c) reduction and standardization of the tax rates levied on companies to eliminate the additional rates, thus diminishing the tax burden of legal entities;
(d) elaboration of legislation that will transform tax inspection into an activity that is more preventive and didactic than repressive in those cases lacking bad faith as manifested by wilful evasion, fraud, etc. Following this line, companies that have committed errors as a consequence of ignorance of the applicable rules will be allowed to amend their errors.

Finally, it should be stated that much has already been done in terms of Brazilian tax policy, but much still remains to be accomplished. It is essential that we never lose sight of the fact that the State is the means and never the end of a free society. For this reason, in a context such as this one, any tax system that is adopted must have the ultimate objective of economic development and, principally, the social development and well-being of the members of society.

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BRAZIL:

The Relevance of Double Taxation Treaties for Developing Countries

Francisco Dornelles

THE PROBLEMS OF DOUBLE TAXATION

International double taxation, which is generally defined "as the imposition of comparable taxes in 2 (or more) States on the same taxpayer in respect of the same subject matter for identical periods"[1], results from the fact that each State has sovereign power to impose taxes on gains, income, capital and assets of both individual and legal entities subject to its jurisdiction. Double taxation occurs when the taxation power is exercised by sovereign States on the same economic fact which is subject to tax in more than one State.[2]

If double taxation occurs between a State which uses the so-called "source or territorial system" of taxation (i.e. tax is imposed on all sources originating or produced in its territory) and a State which uses the so-called "residence or domicile system" (i.e. tax is imposed on the basis of residence or domicile in the country), then international double taxation may have effects other than of a mere fiscal nature because it will interfere with the free movement of capital, goods and persons.

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Income tax is currently one of the most important taxes for most countries; the problem of international double taxation is more glaring in the context of income tax than in the context of other taxes because both the country where the investments originate and the country where the investments are made are willing to tax income derived from the investments.[3] Additionally, it is unanimously recognized that the undesirable effects of international double taxation are even more harmful when the movement of capital, money and technology takes place from and to developed and developing countries.

Developing countries need vast sums of money to finance economic growth and development, investors resident in exporting countries try to invest their funds so as to obtain the maximum yield. Although tax motivation is not the only factor interfering with business decisions to invest in foreign countries, the tax burden plays an important role in investment decisions and very often it is a key factor for potential investors seeking higher profitability.

Problems arising from international double taxation on income and on capital are well known both by governments and private investors. The fact that the income derived by one person is subject to the same tax in 2 or more countries embarrasses investment flows, increases the cost of funds and technology required for development and creates uncertainty for taxpayers.

Moreover, from the point of view of capital-importing countries, double taxation creates additional obstacles for the use of tax systems as an instrument of economic policy because incentives and exemptions designed to attract new investments to certain sectors or geographical areas may be voided by the tax legislation of the country where the investor is resident or where the investment originates.[4]

1. Model Double Taxation Convention on Income and on Capital, Report of the OECD Committee on Fiscal Affairs, Paris (1977) at 7.
2. Francisco Neves Dornelles, A Dupla Tributação Internacional da Renda, Ed. Fundação Getulio Vargas, Rio de Janeiro (1979) at 7.
3. Molteni, Carlos C. Martinez, Los Países Latinoamericanos v la Doble Tributación Internacional, Informe apresentado pas VI Jornadas Latino-Americanas de Direito Tributario, Punta del Este (December 1970).
4. See footnote 2 at page 8.

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THE ELIMINATION OF INTERNATIONAL DOUBLE TAXATION ON INCOME

The domestic legislation of most countries contains provisions designed to eliminate or reduce the effects of international double taxation. As a general rule, such laws provide unilaterally for a credit in the country of residence of the investor with respect to the taxes paid or accrued in the country where the investment was made and from which the income was derived.

This unilateral method, however, is insufficient to remove all the adverse effects of double taxation not only because of its limited effect but also because it does not take into account specific tax holidays and fiscal incentives the host country provides to promote and stimulate foreign investment.

Therefore, many countries, particularly industrialized countries, have been making efforts to eliminate double taxation by way of international tax treaties, the first convention of such kind being dated as far back as 1843. The efforts directed toward the conclusion of multilateral conventions on double taxation quickly appeared to be difficult to implement because of the differences in tax legislation and economic conditions of the countries involved. Experience demonstrated that international double taxation could be more easily eliminated by the conclusion of bilateral conventions, in the context of which 2 countries could remove the differences in tax systems and adapt the systems to each other.[5]

In order to enhance the negotiation of such bilateral treaties, several international organizations have endeavored since the beginning of this century to set up model conventions providing the main rules and methods to deal with the problems arising from international double taxation. The first Model Convention was concluded in 1928 by a Group of Governmental Experts sponsored by the League of Nations, which also promoted preparation of the revised model conventions published in 1943 in Mexico City and in 1946 in London. Those 2 models reflected for the first time at an international level the differences of views between capital-importing and capital-exporting countries, the Mexico Model emphasizing the prevalence of taxation in the source country and the London Model giving privilege to an exclusive taxation in the country of residence of the investor.

More recently, after World War II, the Organization for Economic Cooperation and Development (OECD) prepared a Model Double Taxation Convention on Income and on Capital which was published in 1963 and revised in 1977. This Model, designed to improve the Mexico and London Model Conventions, was the basis for the negotiation and conclusion of 179 tax treaties from 1963 through 1977.[6]

The OECD Model Convention, however, was prepared as a guideline for tax treaties between developed, capital-exporting countries. Because the OECD is an international forum of industrialized nations, the Model Convention prepared by its experts took as point of departure the similar economic conditions prevailing within the OECD Member States and did not attempt to deal with the disparities in economic levels which may exist between countries.

The OECD Model Convention gives ample room to the residence principle, provides for a number of relevant items of income to be taxed exclusively in the State of residence of the investor and does not take into consideration any method for avoidance of double taxation which permits developing, capital-importing countries to use their tax systems as an instrument to attract foreign investment.

Although the OECD Model has been used as a basis for negotiations of tax treaties by several countries in the Third World, in particular Far East countries and on a shorter scale by some Latin American countries including Brazil, the OECD Model soon appeared to be inadequate for these countries. In 1967 United Nations organized a Group of Experts to draft a Model Convention which could meet the needs of developing countries in the negotiation and conclusion of tax treaties with capital-exporting countries. The work lasted for more than 10 years, concluding in 1980 when the Model Double Taxation Convention between Developed and Developing Countries was approved and published.[7] Unfortunately, the expectations of developing nations were to a great extent frustrated.

The U.N. Model Convention was largely based on the OECD Model which was nevertheless recognized as inadequate for the purposes of stimulating investments in developing countries. In addition, the U.N. Model gives rise to the transfer of tax revenue from the developing countries to the capital- exporting countries where most investors are based or have their residence.

The U.N. Model did not include specific mechanisms for the elimination of double taxation such as the matching credit and the tax sparing credit which enables capital-importing countries to use their own income tax legislation as an instrument of economic policy by way of tax exemptions and reductions. For these reasons, the U.N. Model also appears inconsistent with the effective needs of developing countries and does not aid their efforts to attract the foreign capital and technology necessary for their economic growth.

DOUBLE TAXATION TREATIES AND THE NEEDS OF DEVELOPING COUNTRIES

As mentioned above, tax treaties concluded by and between developing and developed nations play an important role in the foreign investment policy of cap-

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5. Id.
6. See footnote 1 at 8.
7. United Nations Model Double Taxation Convention Between Developed and Developing Countries, Department of International Economic and Social Affairs, New York (1980) at 1/12.

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ital-importing countries to the extent that the elimination or reduction of local income taxes may be a key factor in investment profitability and thus may stimulate potential foreign investors to place their capital and technology in the developing country.

Apart from the specific purpose of eliminating or reducing double taxation on income (and on capital, as the case may be), developing countries should bear the following goals in mind when negotiating and concluding tax treaties with capital-exporting countries:

(a) to increase the inflow of capital investments, either directly or by way of import financing or debt-equity swaps;
(b) to permit and preserve the use of their tax systems, particularly their income tax legislation oriented towards the promotion of less developed areas and sectors of the local economy, as an instrument of economic policy, by preventing tax incentives and exemptions from being voided or absorbed by the income tax legislation of foreign, capital-exporting countries;
(c) to reduce the cost of foreign capital, funds and technology which are required to finance and implement their development projects;
(d) to assure foreign investors that some tax ceilings will be imposed in a manner so that income derived from foreign investments in the country shall not be taxed beyond certain limits at least for a reasonable period of time.

In order to attain such goals, developing countries should try to insert some basic provisions in their tax treaties concluded with developed countries, to the effect that:

(a) income derived from investments made in the developing country and which are subject to tax therein shall be exempted from tax in the country of residence of the investor or, if not exempted, the country of residence shall grant the investor a tax credit for taxes paid on the income in the developing country;
(b) coupled with the previous provision, whenever the taxes on items of income such as corporate profits, dividends, interest, royalties and payments for technical services and technical assistance when derived by any resident of a foreign country are reduced or eliminated by virtue of domestic laws of the developing country, the country of residence of the investor shall exempt such income from tax or shall grant its resident a credit corresponding to the tax which was reduced or eliminated in the developing country, just as though the tax was not reduced or eliminated;
(c) any reduction of or exemption from taxes agreed upon by the developing country in the context of the double taxation treaty should constitute an actual benefit to the foreign investor and should not be passed on as a transfer of tax revenue to the Treasury of the country of residence of the investor;
(d) withholding tax on corporate profits, dividends, interest, royalties and payments for technical assistance and technical services derived by foreign investors in developing countries could be limited to a maximum rate for a specified period of time.

These provisions are reflected in certain methods and mechanisms of tax treaties for the avoidance or elimination of double taxation which are discussed below.

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Basically, provisions inserted in tax treaties with the purpose of eliminating (or reducing, as the case may be) international double taxation on income may be summarized as follows:

A. Exemption methods

1. Full exemption

According to the full exemption method, income is totally excluded from the tax basis of the taxpayer for income tax purposes and it is not taken into consideration for the determination of progressive rates which apply to the global income of the taxpayer in its country of residence.

The full exemption method, when adopted by an industrialized country, appears to be an advantageous method for capital-importing countries to attract foreign investments, insofar as it ensures that any tax benefit provided for by the laws of the developing country may not be cancelled out by the tax laws of the country of residence of the investor.

2. Exemption with progression

Under this method, income is exempted from tax but it is taken into consideration in the computation of the overall tax liability of the taxpayer in his country of residence. In other words, income derived from one country by a person who is a resident in another country is excluded from tax in that other country but it is added to all other items of income of that person for purposes of determining the progressive rate of tax applicable to that person.

This method normally only applies to taxation of individuals, which is generally based on progressive rates. This method has been adopted by both the OECD and U.N. Model Conventions for the elimination of double taxation but the effects of the exemption with progression method are clearly limited by its function and scope.

B. Imputation methods

1. Ordinary imputation

While the exemption methods refer to income, imputation methods refer to the tax which is imposed on the income. Under the imputation methods, double taxation is eliminated (or reduced) by way of a credit in the country where the income was derived.

The credit may be subject to certain limits and if so,

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the method is called ordinary imputation. Such limits may be based on the worldwide income of the taxpayer ("overall limitation") or on income derived from each foreign country ("per country limitation"). The limits are designed to prevent foreign taxes from being credited against domestic taxes imposed on income derived in the country of residence of the investor.

Traditionally, this is the method adopted in the OECD Model Convention which is commonly used in tax treaties concluded between capital-exporting countries where outflows and inflows of funds are mutually comparable.

2. Full imputation

Under the full imputation method, the credit to be claimed by the investor in his country of residence is not subject to any limitation and it fully takes into account the total amount of foreign taxes paid by the investor.

Although imputation methods, either ordinary or full, may reduce or eliminate double taxation they appear to be inadequate for the purposes of capital-importing countries because, as in case of the unilateral credit, they do not take into account tax incentives prevailing in those countries for the attraction of investment.

C. Deduction method

The deduction method has a very limited scope and effect for the reduction of the overall tax on income derived from the source country by a resident of another country because the tax paid in the source country is merely subtracted from the gross income subject to tax in the residence country so that the tax in the residence country is assessed on the net foreign income of the taxpayer.

D. Sharing method

The sharing method is also a limited method, consisting of the division between 2 countries of their taxing power on income derived from one country by a resident of the other country.

After determining a ceiling rate of tax, the 2 countries set up the portion of such rate which will apply in each country. In some cases, this method may have an effect similar to the imputation method with the same limited scope as the latter.

MECHANISMS AND MEASURES FOUND IN DOUBLE TAXATION TREATIES

More relevant than the reviewed methods against international double taxation which may be adopted either through unilateral measures or by way of treaties, are a number of specific mechanisms in the context of treaties. These mechanisms have a crucial importance in the treaties between developing, capital-importing countries and industrialized countries because they more effectively permit developing countries to apply their own income tax laws to attract foreign investment.

The most relevant mechanisms which may be included in double taxation treaties are: (1) permanent establishment; (2) tax sparing; (3) matching credit; (4) investment credit; and (5) tax deferral.

A. Permanent establishment

Permanent establishment is one of the most relevant concepts in double taxation treaties because it is the basis for the taxation of business profits from foreign activities of a company. Under the OECD Model Convention, the foreign profits of a company are only subject to tax in the country of source if such profits are derived through a permanent establishment of that company and insofar as such profits are attributable to that permanent establishment. According to the OECD Model, a permanent establishment requires: (a) the existence of an installation; (b) with a certain degree of permanence; (c) which performs any activities for the company which are not of a preparatory or ancillary nature.

Under the treaties, where double taxation is eliminated by the exemption method in the residence country, the concept of permanent establishment does not have much relevance because the taxing power of business profits remains exclusively in the hands of the country where the activities are performed, i.e. the country of source.[8] From the point of view of developing countries it is relevant to enlarge as far as possible during negotiations of double taxation treaties with developed partners the scope of permanent establishment in order to increase their taxing power in the greatest number of circumstances.

B. Tax sparing

Tax sparing is used to prevent any reduction or exemption from tax in the country of source from being transferred to the Treasury of the capital-exporting country. This method ensures that tax incentives originally granted by the source country inure to the benefit of the foreign investor and are not nullified by the increased tax paid in the country of residence. Sometimes tax sparing may apply when the tax is reduced or eliminated in the source country by virtue of the treaty itself and not by any tax incentive found in the domestic legislation of the host country.[9]

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8. This provision was, for instance, inserted in the Cartagena Model Convention approved and adopted by the Andean Pact countries although in practical terms taxation of profits derived from the performance of business activities within any of those countries implicitly requires the existence of a fixed place of business in that country.
9. The OECD Model Convention does not provide for any tax sparing mechanism in its context but a reference to its adoption in tax treaties is made in the commentaries as follows:
   The State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general

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Under the tax sparing provision, the country of residence of the investor grants a credit which corresponds to the tax which would be imposed in the country of source of the income if such tax had not been reduced or eliminated under a tax incentive program or by virtue of the treaty itself.

The tax treaty concluded between Brazil and Japan adopts a tax sparing provision with respect to business profits derived from Brazil by a company which is resident in Japan, in such a manner so that Japan shall allow as a deduction from its corporate tax on the profits of such company an amount corresponding to the Brazilian corporate tax as computed at a 30% rate thereon, irrespective whether the tax effectively paid in Brazil by virtue of prevailing tax incentives is lower than that rate. However, if the Brazilian corporate tax rate is reduced to 25%, for instance, this new rate shall then prevail for tax sparing purposes in Japan.

C. Matching credit

The matching credit is by far the most relevant treaty provision for developing countries. It consists of a tax credit in the country of residence which is computed on the basis of a pre-established rate which is higher than that prevailing in the country of source. The matching credit has great significance for capital-importing countries because it permits them to use their own income tax as an instrument to attract foreign investment into economic sectors which they desire to stimulate. By virtue of the matching credit, the tax incentives resulting from any reduction in or exemption from tax given by the developing country shall inure only to the benefit of the investor, who will be granted in its country of residence a tax credit as computed at the tax rate provided for in the treaty and not at the effective rate then prevailing in the source country, as would be the case if an imputation method were adopted (as described above).

The matching credit has similar purposes and effects to the tax sparing provision. However, under the matching credit the rate at which the credit in the residence country shall be computed is previously established in the treaty, while under tax sparing the credit rate is contingent on the prevailing rate in the source country and therefore the amount of credit may decrease by virtue of reductions of tax rates in the source country.

In view of this difference, the matching credit appears to be more convenient than tax sparing for capital-importing countries in the management of their tax policy because through the use of the matching credit such countries may reduce or waive their taxes under internal laws for purposes of attracting foreign investments without risking that the benefits of reduction or elimination of taxes may be transferred to the Treasury of the country of residence of the investor and that they may be nullified by a corresponding reduction of the tax credit which shall be granted by the country of residence.[10]

Brazil has adopted the matching credit with respect to dividends, interest and royalties in most of its double taxation treaties concluded with developed countries when such items of income are not exempted from tax in the country of residence of the investor. For example, in the treaties with Austria, West Germany, Sweden and Canada the fixed credit rate is either 20% or 25% as the tax effectively paid in Brazil is either computed at a rate not exceeding 15% or in some cases is totally eliminated. Under the revised treaty with Japan (in force since 1978), a Japanese-resident investor may enjoy a tax credit in Japan with respect to dividends, interest and royalties derived from Brazil which shall never be less than 20% of the income (and which shall reach 25% in case of dividends and royalties) even if Brazilian tax on such items of income is at any time reduced or abolished.

D. Investment credit

The investment credit, which was primarily used domestically by some developed countries, may also be used to attract capital investments into developing countries. It is determined as a percentage of the invested amount which may be credited against the tax to be paid by the investor in its country of residence.[11]

In the context of double taxation treaties, investment credit may be very helpful for capital-importing countries not only to provide for the amounts or percentage of investments but also to select the most convenient kind of investments which would be eligible for the credit in the country of residence of the investor.

E. Tax deferral

Under the tax deferral provision, the capital-exporting country shall only impose its taxes on foreign-source income when such income is effectively received by its resident. Therefore, the payment of taxes in the country of residence may be delayed until the corresponding income is effectively earned by the investor.

This provision is extremely important for capital-importing countries because it encourages the foreign investor to keep his profits reinvested in the country of source instead of repatriating the profits. Such effect may be increased if the country of the investor's residence provides for a tax credit only with respect to

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legislation on such amount as limited by the Convention (....) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development.

10. The OECD Model Convention also refers to the matching credit as a possible mechanism in tax treaties but the fact remains that the Model does not contemplate it in any of its provisions. These are the commentaries thereon:

> As a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate. (op. cit. p. 160, item 73b)

11. Under the treaty concluded in 1967 between Brazil and the United States, the investment credit was fixed at a 7% rate for U.S. investments made in Brazil, but the treaty has never entered into force.

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taxes effectively paid in the source country, because in case of repatriation of profits the investor would not be eligible for any credit in its country of residence for taxes reduced or eliminated under a tax incentive program in the country of source; consequently, the investor would be discouraged from repatriating his profits.

As far as the investor is concerned, the deferral mechanism also permits him to enjoy certain tax benefits in the country of source when domestic laws of that country provide unilaterally for any reduction of tax in case of reinvestment of profits.

CONCLUSION

International double taxation of income and capital is recognized as one of the major problems for the free movement of capital and funds throughout the world. This problem affects developing countries more adversely than industrialized nations because capital-importing countries are short on technology, funds and productive capital necessary to finance their economic growth.

In order to attract foreign capital and technology, developing countries tend to reduce or eliminate taxes on income derived from activities in their territory thus removing unilaterally the excessive taxation. This sacrifice, however, is often nullified by tax laws of industrialized countries where that capital and technology originate. As a result, tax revenues which are lost by developing countries are merely transferred to the Government of capital-exporting nations and the incentives created to stimulate foreign investments disappear.

The most appropriate strategy for developing countries to deal with this problem is the bilateral negotiation and conclusion with their industrialized partners on a case-by-case basis of tax treaties providing not only that double taxation between the 2 countries may be eliminated through the traditional methods but also that tax incentives prevailing in the developing country to attract investments may be preserved by specific mechanisms mutually agreed upon between the 2 treaty partners.

When developed countries do not accept an exemption for income derived by their residents in developing countries, the matching credit and tax sparing are the most appropriate provisions in tax treaties to reach satisfactory results for developing countries because they protect the tax incentive programs of these countries without interfering or damaging the economic policy or tax revenues of developed countries. In other words, those mechanisms put into practice an effective cooperation in the international tax field between countries with different levels of economic development.

IFA NEWS

PAKISTAN BRANCH

On 23 May 1989, the Pakistan Branch of IFA held a seminar entitled "An Overview of Direct Taxes in Pakistan". A 6-man delegation from Bangladesh participated in the seminar. Various papers were presented by highly-placed dignatories and senior professionals.

SWISS BRANCH

The members of the Swiss IFA Branch held a meeting on 8 June 1989. The following persons were re-elected as members of the General Council of IFA: Dr. A. Burckhardt and Mr. P. Spori. Dr. K. Stocker, Dr. H.K. Lüscher, Dr. Desax and Mr. Pierre Gillioz were (re-)elected as substitute members of the General Council.

Dr. Th. Faist resigned and Dr. A. Knechtle was elected as a new member of the Board of the Swiss IFA Branch.

During the meeting, the 1988 activity report of the Swiss Branch was approved. From this report, it appears that on 31 December 1988 the Swiss Branch had 436 members (of which 80 members were corporate members). During the year 1988 3 meetings of members were held:

(1) On 4 February 1988 a meeting was held in Basel during which the new Swiss marriage law and the tax implications thereof (including the problem of intercantonal double taxation) were discussed.

(2) On 9 June 1988 a meeting was held in Zurich during which future tax policy plans in Switzerland, the proposals for a turnover tax reform, the proposals made by the working group "Place financière suisse" with respect to stamp duties and the problems relating to the introduction of an energy tax were discussed.

(3) During the meeting on 3 November 1988 in Bern the Swiss national reports for the 1989 IFA Congress in Rio de Janeiro were discussed and approved.

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BRAZIL:

Fiscal Issues and the 1988 Constitution

Prof. C.A. Longo

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I. SLICING THE FISCAL "PIE"[1]

The allocation of public spending among different levels of government should be examined in conjunction with tax revenues. Theoretically, the Federal Government could collect all taxes and allocate them to States and Municipalities according to pre-established policy criteria. However, this form of revenue allocation would become a political issue. On the other hand, some measure of fiscal autonomy is desirable both politically and economically. After all, factors such as local peculiarities and available natural or acquired resources, community preference for certain public services and the extent of government involvement in the economy are not easily convertible to standard formulas of fiscal revenue allocation.

Allocation of public expenditure and revenues among different levels of government depends not only on a country's cultural background and historical opportunities, but also on the adoption of either clearly centralized or decentralized fiscal policies. Consequently, it is practically impossible to have a hard and fast rule for the allocation of revenue and expenditure. On the basis of economic theory assumptions, Musgrave[2] developed a model of fiscal federalism that can be used to advantage in discussing how to slice the "fiscal pie" with respect to uses and sources of funds. The model assumes an asymmetric mobility of factors. The capital factor is fluid between jurisdictions regardless of size, while the labor factor is increasingly less mobile as one moves from local to national jurisdictions. The key government functions are to provide public utilities, reduce social inequalities, and stabilize prices and activity levels. In order to finance its activities, the government has taxes, charges and the operating income of public corporations. Two sets of collection criteria apply, i.e. the ability to pay and taxation for value. Personal taxes (income and property) fit into the first criteria, while local (property) taxes, charges and rates fit into the second.

It follows from these assumptions that any public spending which primarily benefits a local community should not be financed by personal taxes. Otherwise it might encourage the migration of (wealthy) people and resources whose cost-benefit ratio for public utilities is substantially higher than average, while attracting people in the reverse situation. In this sense, the costs and benefits from the provision of public utilities should be allocationally neutral, i.e. paid for and appropriated within each respective jurisdiction. Thus real property tax is, in essence, a local tax whose costs and benefits reflect on prices.

Likewise, the value added tax properly equalized at customs (according to the point-of-destination principle), or the sales tax may be confined to the jurisdiction benefiting from such public spending. For similar reasons, the government's allocational and stabilizing roles should be centrally located.

In short, under this model, personal taxes (income or consumer) finance public utilities of national interest at a central level; they also promote stabilization and redistribution policies. Local governments would be limited to tapping their own taxable bases (real property, local taxes and rates) to finance essentially local services. Intermediate government jurisdictions would finance public utilities (specifically limited as far as benefits are concerned) through indirect taxes by trying to minimize fiscal externalities and adopting the principle of destination on inter-jurisdictional transactions.

The issue of function allocation among government levels is more complex than that of tax allocation. Analysis of the benefit accruing to public utility users is clouded by the collective nature of their provision. Generally speaking, all government levels contribute to the provision of such services especially when they are not strictly defined; e.g. health, where all government levels share responsibilities. However, if an attempt is made to break down costs, for example, between "preventive health" versus "curative health care", the former should be assigned basically to the central government and the latter to a local jurisdiction while both types of health care would be provided at the State level.

What would be the rationale then for an optimum allocation of functions? The issue is not merely economic or regulatory, i.e. which services should legally be assigned to this or that level of government? This issue should be approached as a matter of practical judgement to be settled in line with political, economic and administrative criteria according to custom and prevailing needs. In fact, the role of government continues to grow and economies today are much more integrated than previously. As a result, the concept of separation of government functions can be replaced by one of "cooperative federalism".

Too much financial centralization weakens the independence of local government. One solution often employed to overcome the shortage of local resources

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1. Adapted from C.A. Longo, "A distribuição dos Gastos e Receitas Públicas entre niveis de Governo: um enfoque econômico," in *Revista de Finanças Públicas* No. 369 (Jan./Mar. 1987).
2. R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice*, 3rd Edition, McGraw-Hill, New York (1973).

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in Brazil has been to transfer the actual work and functional management to higher government levels. The problem is more acute in the provision of urban services than in the so-called social roles of government (health care, education, etc.). The provision of water, sewage disposal and mass transportation, for instance, is less efficient when operated on a reduced scale. This is one of the reasons for the virtual "State monopoly" of these utilities in Brazil, imposed by federal law but often at odds with the interests of local autonomy.

Health care, medical care and university education are almost entirely left to the Brazilian Federal Government, particularly in the poorer States. Funds allocated to health care are nearly all channelled to the national social security system and come from contributions paid by employers and wage earners. In the 1970s, Law No. 5692 (August 1971) proposed the gradual transfer of elementary school expenditure to local governments. The failure to enforce this law was due to the imbalance in funding allocation. Since taxes were centralized, most local governments were unable to assume immediate responsibility for supporting elementary school costs despite the offsetting measures available (fiscal transfers and educational aid to workers). The "State monopoly" over basic education is now considered as an alternative solution. In this scenario, State governments would take charge of education in cities and towns, while local governments would provide education in rural communities. However, States cannot take on social services, medical care and education without deriving the proper counterpart in tax revenues. As for urban utilities transferred to the States, funding is provided by rates charged by public utility companies.

The basic issue still unanswered in Brazil, therefore, is how much to transfer, not just in terms of sources but also in terms of use of fiscal revenues, to lower government levels. Revenue centralization and the national interest suggest that the definition of "basic guidelines" and the setting of "general standards" should remain the province of the Federal Government. Decisions on expansion, location and quality of services, however, may be delegated to subnational units according to the physical scope of the benefits provided. Lower level governments would carry out the actual programs. However, care must be taken to prevent direct interference of the central government in any decision-making process by virtue of its control of funding sources. This can be achieved by decentralizing the current Brazilian tax structure and establishing a mechanism for intergovernmental transfer of revenues under a counterpart arrangement to vary according to per capita income.

II. TAX REFORM IN THE CONSTITUTION[3]

The changes introduced in the tax section of the new Constitution have come to be called a tax reform. Care must be taken not to overgeneralize the term "reform". In 1967, the State sales and consignment tax (IVC) was replaced by a sales tax (ICM) which bore little resemblance to the old arrangement. The ICM was non-cumulative and its rates and exemptions were not set at State level as they were for the former IVC. This is a typical example of tax reform whereby the collection pattern was substantially changed by the new legislation. The tax packages periodically introduced in Brazil at the close of each year are usually attempts to close fiscal gaps and shorten collection periods; thus rather than a true reform are really circumstantial adjustments.

Reform also does not mean toppling the entire tax collection framework already in force. However, the difference between proposing an "ideal tax" and a "tax reform" must not be overlooked. For example, a type of income tax can be devised to cover the total income earned by all individuals in the work force. In practice, this tax does not apply, particularly to a low or medium income society or to one historically or culturally disinclined to disclosing the actual amounts involved in individual businesses. In this sense, considerations such as historical background, culture and level of development must be acknowledged when an innovative approach is proposed; otherwise it might be doomed to failure from the outset.

The "tax reform" passed by the Constitutional Assembly is closer to a circumstantial adjustment than to a true reshaping of the tax collection structure. In point of fact, a Constitution is not the proper place to define a country's tax arrangement which must be the object of regulatory and statutory laws. Actually, the income tax legislation is totally separate from the Brazilian Magna Carta. The Constitution creates taxes, establishes jurisdictions and allocates tax revenues between the 3 levels of government. On value added tax, it even sets the taxation range on interstate trade and exports. In essence, the new Constitution has wrought only minor changes in the current tax collection pattern but introduced major alterations in tax revenue allocation to the different government levels.

As compared to the 1988 version, the 1967 tax reform might be termed elitist and centralizing. It was drafted by a special commission and promptly approved by the Executive. In line with the prevailing philosophy, the Union centralized jurisdictions, tax legislation and allocation. Therefore it is not surprising that the wording of the tax section in the new Constitution adopts the reverse approach. This time little emphasis was given to the proposals arising from the discussions of special commissions. Rather than study how best to collect and allocate taxes and revenues, the congressmen chose the easy way out, i.e. to increase the share of their States and Municipalities in federal revenues.

The 1988 Constitution provides for a substantial increase in the share of the main federal taxes channelled to States and Municipalities. In the longer run, the question is whether this is the best means of decen-

3. From C.A. Longo, "Aspecto Econômico da Repartição das Receitas Tributárias", in *Academia Brasileira de Direito Tributário* – 1st National Congress on Tax Studies (1988) at 161-174.

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tralizing taxes and revenue allocation throughout the 3 levels of government. Nearly half of the income tax and excise tax will go to States and Municipalities. Such transfers have been increasing over the past few years: before 1980, subnational governments took in barely 20% of those taxes.

Under the system set forth in the new Constitution, the revenue available to the Federal Government will decline from 46% to 35%, the States' share will rise from 36% to 42%, and the Municipalities will increase from 18% to 23% by 1990. (See Table below.) To offset the revenue losses incurred by the Union, no special counterpart transfer is provided for. In fact, expenses may even increase considering the pledges and deposits needed to guarantee a bottom limit for certain essential services (culture, education, justice, etc.).

BRAZIL

Spending per government level

In percentages

	1975	1980	1985	1990
Federal	50.0	49.0	46.0	35.0
State	36.0	35.0	36.0	42.0
Municipal	14.0	16.0	18.0	23.0

Source: SRF, Ministry of Finance.

The tax changes introduced by the Constitution are an example of what should not be done in terms of fiscal decentralization. They are merely an attempt to enhance the financial condition of States and local governments at the expense of the Union with no concern whatsoever for generally accepted principles of fiscal federalism. In essence, the changes increase the share of federal taxes going to local governments and do not stimulate either local efforts at tax collection or effective independence.

Decentralizing the tax power of jurisdictions is not the same as spreading the proceeds of tax collection. Decentralizing means to grant autonomy both to collect and to spend, according to available resources and local requirements. Income decentralization merely transfers funds according to centrally defined policy criteria regardless of local decisions or tax collection efforts.

The new sales tax on goods and services (ICMS) is indeed an improvement on the former ICM. The tax events now include goods and services covered until recent times by federal single-stage taxes. States are given some degree of liberty to decide on rates and exemptions on an individual basis. Further advances might have been achieved, for example, by including services in general under the ICMS but these are still levied through the local services tax (ISS). Further alternatives must also be sought for Municipalities to more effectively explore their own tax bases. A step in that direction would be a merger of the urban property tax (IPTU) with the rural property tax (ITR) where both allocation and management would be handled by the local government.

Since 1985 the Federal Government has been forced to surrender to subnational units in tax sharing. In fact, until the mid-1970s States and Municipalities took in just 10% of the main federal tax revenue: income tax and excise tax. Immediately before the new Constitution was passed this amount had increased to 33% and may reach the 50% mark within the near future. In addition, States and Municipalities have had their taxable base on value added tax expanded (ICMS), they may now levy new taxes such as a tax on inheritance and donations and a tax on retail fuel sales, and may further levy a 5% surtax on income tax. They are also entitled to appropriations from a fund to offset export duty exemptions. At the Federal level, the single-stage tax on fuels, electricity, communications and minerals, previously pro-rated between the 3 government levels, has become extinct. The Union will be entitled to levy a useless tax on large fortunes and will retain residual jurisdiction over the levying of new taxes.

The financial losses for the National Treasury caused by these actions have been estimated at about 17% of its 1987 revenues, to increase to approximately 21% by 1993. Conversely, financial gains for the States range from 14% to 16% of their available revenues between 1989 and 1993. The more substantial increases will be shared by the less developed States of the North and Northeast that will benefit from major transfers from the Participation Funds (FPE and FPM), allocated according to geographical area, population and inversely to per capita income.

For Southern and Southeastern States, the key determinants for additional revenues will be extension of the sales tax, the income tax surcharge and the new Export Fund. The financial gains in the North and Northeast will gradually increase over the next 5 years as their share in the Participation Fund expands accordingly. In the South and Southeast, the financial impact of tax changes will be immediately felt because it correlates to the extinction of the single-stage taxes and creation of both the income tax surcharge and the Export Fund.

The 1989 Federal Budget must compensate for losses by providing relief on taxes that directly benefit local administrations. In late 1988, the Executive began the so-called "dismantling operation" to transfer to State and local governments the 1989 Federal Budget allocations for pre-school and elementary education, and urban facilities (especially transportation, water and sewage facilities) previously supplied by the Federal Government, in particular to less developed States. Naturally there is a risk that such relief may not materialize for political reasons and this might result in a higher public deficit.

A better revenue distribution through the reshaping of key federal taxes was achieved by the 1988 Constitu-

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tion. Extinction of the single-stage taxes and the corresponding expansion of the taxable ICM base were surely a step forward: single-stage taxes no longer performed the function for which they were created and the ICM moved toward universal application. However, the increase in the share of income tax and excise tax assigned to States and Municipalities is ill-advised. It discourages tax collection efforts and distorts revenue application in all 3 levels of government. Henceforth, the Union will have little incentive to either change or even increase its traditional taxes because the proceeds to a great extent must be handed over to other jurisdictions. So long as local governments can tap the substantial shared revenues, they will be unable to accurately assess and explore the cost-benefit ratio of services provided because of the large gap between federal internal revenue affairs and the actual taxpayer. This stimulates what one might call a "fiscal free-ride" by State and Municipal governments, and the creation of new forms of taxation at the Federal level.

A redistribution of taxes and revenues between government jurisdictions should involve not a decentralization of income but rather a decentralization of tax jurisdictions. The self-government of States is a direct function of the degree of self-financing and freedom to set rates and exemption criteria in their respective taxable bases. Therefore, ideally these government levels would be limited to the more universal taxes on value added and property (land, both urban and rural). The Union would handle the more comprehensive individual income tax. If properly trimmed – with a relief to corporations by integrating corporate income to that of shareholders – this would replace a number of other current or future para-fiscal charges like turnover tax (Finsocial) and compulsory loans. The State and local participation funds would be reserved a less ambitious role: to pro-rate 25% of all federal tax revenues in the inverse proportion to per capita income of each region instead of a higher percentage of just a few selected taxes.

III. CRITIQUE ON THE PUBLIC FINANCE CHAPTER

The former Constitution (Amendment 1 of 1967 to the January 1967 Constitution) dealt with the budgeting procedure in the chapter on the Legislative Branch. The new Constitution has an entirely separate section for the Budget.[4] The main criticism directed against the new wording is a matter of form: confusing and prolix. Good budgeting practice does not depend on written rules. Enforcement and a faithful commitment to ground rules such as consistency, universality and timeliness often result from jurisprudence and tradition. In some countries it has materialized in the form of statutory laws, as Budget practices facilitate information and provide guidance to users. Thus it would have been more useful simply to amend the old constitutional text because it was concise and its shortcomings already familiar.

It should be emphasized that as far as budgeting technique is concerned – submission of Budget bills, extension of extra appropriations, amendments by congressional committees, etc. – the new wording is not much different from that in the old Constitution. Some progress has been made, however, in a few major issues of concern. The new Constitution tries to curb the "indirect" financing of government spending which does not go through Congress but is authorized by official credit agencies, the Central Bank in particular. This gap was obvious in the preceding legislation where Complementary Law No. 12 (November 1971) regulating Art. 69 of the Constitution (1969) gave the Central Bank the responsibility for managing all federal debt liabilities not already covered by Budget appropriations.

Presidential decrees issued before the new Constitution, however, had already begun to dry up those leaks from the Federal Budget. In fact, as part of the measures taken to merge the Federal Government accounts, in 1987 the Executive Branch added to the budgeting procedure statements on source and application of resources from special funds and programs (subsidized credit) and on the domestic and foreign debt service previously handled by the Central Bank. To judge by current practice, the new Constitution does not reduce the possibility of leaks to any major extent. Furthermore, complementary laws will have to regulate the fiscal year for the Union, its length, deadlines, legislative procedures, preparation and development of multi-annual plans and annual budgets. Finally, statutory laws will be required to regulate the financial and capital management of the government and its agencies, as well as to set the rules for appropriation and operation of federal funds.

The new Constitution contains some interesting additions. First, a "budgetary guidelines law" was designed for the annual definition of goals and priorities of the Executive for the subsequent fiscal year. This document will serve both to "guide" the draft of a Budget bill and to announce "changes" in tax legislation or in the disbursement "policy" of federal funding agencies. The need of a special law to provide for what is usually included in the appropriation bill is questionable.

The second new item is the limitation set on credit Budget operations. The deficit must not exceed an amount equal to capital spending, phased in over the next 5 years. This is a preventive and therefore praiseworthy measure. However, it could be criticized for the tight constraints it will impose for analysis, discussion and approval of Budget appropriations in a necessarily changing world of economic policies.

According to the new Constitution, the Executive must attach to the Budget appropriation bill sent to Congress a financial state of accounts of its social security system, and another to cover "tax expenditure". The Budget for tax expenditure is a balance of revenue losses resulting from tax exemptions and subsidies ex-

4. Title VI – On Taxation and Budget, Chapter II on Public Finance, Section II of the Budgets.

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tended by the Federal Government. The social security Budget covers all related entities and agencies either directly administered by the Federal Government or through its agencies. Both provisions are desirable for the sake of transparency, evaluation and control of the Ways and Means Law. However, they are already in force for the 1989 Budget. The new Constitution turns the Joint Senate and House Committee from a pro tempore body – meeting annually to discuss and issue an opinion on the appropriation bill – into a permanent one, while the Executive is required to submit bimonthly progress reports on the Budget.

The confused and involved wording of the Constitution is even more apparent in Section I (general provisions) of the Chapter on Public Finance. A complementary law will regulate public finance, public debt, guarantees, issue and redemption of securities, monitoring of financial institutions, exchange operations, and functional compatibility of government lending institutions, etc. It is expected that a law will be enacted to regulate, as it does, all matters of public finance, but not necessarily a complementary law. For example, the current legal framework of the financial and monetary system (Law 4595 of December 1964), which was a real institutional reform at the time, had nothing to do with the Constitution.

The level of detail and inconsistency reaches a peak on the issue of setting monetary policy rules. It starts by stating that the Union is responsible for issuing currency.[5] On the other hand, the Central Bank is forbidden to either directly or indirectly extend loans to the National Treasury or any other agency or entity except for financial institutions. In addition, the Central Bank is authorized to trade in the open market to control the money supply and interest rates.[6] The question is, then, with an independent Central Bank – which seems to be the intention here – should the Union decide on currency issuing? Even if this assumption is acceptable, the constitutional provisions do not prevent the Central Bank from extending loans to financial institutions (as it would not otherwise be a Central Bank). If it is so, the monetary authority may continue to finance the Budget deficit through Banco do Brasil, for instance. Therefore, banning monetization of the deficit and granting the Union a monopoly on the issue of currency in the Constitution are measures both unnecessary and ineffective.

5. Title IV on Organisation of Government Branches, Chapter I on the Legislative Branch, Section II on the Responsibilities of the Federal Congress, Art. 48, item xiv.
6. Title I on Budget Taxation, Chapter II on Public Finance, Section I General Provisions, Art. 164.

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BRAZIL:

National Tax System – The 1988 Constitution

N. Latorraca and J.G. Barbuto

The national tax system established by the 1988 Constitution, and in effect as from 1 March 1989, guarantees that prior legislation shall apply in all areas which are not incompatible with current constitutional provisions until such time as the supplementary legislation required by the Constitution is published.[1] Among other matters, it is incumbent upon supplementary legislation to establish general tax legislation rules with particular reference to the definition of taxes, taxable events, calculation bases, taxpayers, tax obligations, tax entries, statutes of limitation and prescriptive periods.

Chapter 1 of Item VI of the Constitution is dedicated to the national tax system, and Art. 145 provides that political entities (the Federal Government, the States, the Federal District (Brasília) and the Municipalities) are empowered to levy the following taxes:
(i) taxes in general;
(ii) rates; and
(iii) levies on improvements, arising from public works.[2]

Regarding taxes in general, the Constitution has established that "whenever possible" this type of tax shall be personal in character and imposed in accordance with taxpayer's economic capacity. In order to ensure that these objectives are fulfilled, the tax authorities have the constitutional right to identify the taxpayer's assets, earnings and economic activities, provided the rights of the individual are respected.

The Constitution also provides that rates may not be computed on the same calculation basis as taxes.

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TAXES – CONCEPTS AND TYPES

Art. 3 of the National Tax Code (CTN) defines a tax as follows:

> A tax is any compulsory pecuniary installment, in currency, or whose value may be expressed in monetary terms, which does not represent approval of an illicit act, is instituted by law and collected by means of a specifically related administrative act.

The individual components of a tax can be briefly analyzed as follows:[3]

1. Pecuniary installment

Excluded is any installment which cannot be monetarily represented; accordingly, no tax charge can be made for payment in the form of personal services rendered.

2. Compulsory

This component represents the essence of a tax and its obligatory nature. A tax does not derive from a negotiation between parties. It derives from the manifestation of the sovereignty of the State, which empowers it to demand an obligatory installment from all who have a contributory capacity, as expressly defined by law.

3. In currency or whose value may be expressed in monetary terms

The tax may be fixed in cash or a unit which can be

1. The complementary legislation is required by Art. 146 of the Constitution.
2. In addition to taxes in general, rates and improvement levies, the Constitution refers to 2 other types of tax, i.e. compulsory loans and contributions.
3. The tax concept covers taxes in general, rates and levies on improvements.

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translated into cash, such as the OTN (Federal Treasury Bonds), sealed paper, revenue stamps, etc.

4. Which does not represent approval of an illicit act
Pecuniary installments representing the approval of illicit acts are legally excluded from the concept of a tax.

5. Instituted by law
Instituted by law is a constitutional principle. Under Art. 150 of the Constitution, the Federal Government, the States, the Federal District (Brasília) and the Municipalities are prohibited from creating or increasing a tax which has not been established by law.

6. Collected by means of a specifically related administrative act
This aspect requires that tax collection be carried out by a specific administrative entity and it may not be exercised by any other entity. Collection must be connected to an administrative activity and it cannot have any discretionary characteristics, i.e. the public administrative entities must act strictly in accordance with tax legislation and not at their own discretion.

TAXES IN GENERAL

The CTN defines a tax as a levy the obligation for which is generated by a situation independent of any specific State activity relating to the taxpayer (Art. 16). The essential factor in the concept of a tax, therefore, is its general nature. A tax is a levy whose objective is to cover general public needs, as distinct from rates whose basic characteristic is their connection with the rendering of public services.

RATES

The taxable event is the regular exercise of governmental authority or the effective or potential utilization of specific and divisible public services rendered to taxpayers or placed at their disposal. This concept is described in Art. 77 of the CTN and in Art. 145 of the Constitution, which highlight the remunerative nature of rates and their connection with the rendering of public services by the State.

Governmental authority is considered to be the act of public administration which, by limiting or disciplining rights, interests or liberties, regulates the practice of, or abstention from, an act in the public interest relating to security, hygiene, public peace and order, the disciplining of production and of the market, the exercise of economic activities which depend on the franchising or authorization by State authorities, the respect for property, and individual and collective rights.

LEVIES ON IMPROVEMENT

Finally, there are the contributions of which the improvement levy is the most common and which is defined by the CTN as being a tax levied to cover the cost of public works which increase property values. The total limit is the expenses incurred and the individual limit is the increase in value to each benefiting property resulting from such work (Art. 81).

AUTHORITY TO TAX

The political entities constitutionally empowered to institute taxes are the Federal Government, the States, the Federal District (Brasília) and the Municipalities.

Art. 6 of the CTN provides that the constitutional attribution of the power to institute taxes comprises full legislative authority, subject to constitutional limits. Art. 24 of the Constitution empowers the Federal Government, the States and the Federal District (Brasília) to legislate both tax and financial law. Art. 30 authorizes the Municipalities to supplement Federal and State legislation, where permitted, and to institute and levy taxes within their jurisdiction. The taxing authority of these political entities is described in Arts. 153-156 of the Constitution.

Art. 7 of the CTN provides that the power to tax cannot be delegated. This, however, does not prevent one public body from conferring the authority to collect and monitor taxes, execute laws, services, administrative acts or decisions on tax matters. Conferral of authority, which is subject to revocation at any time, consists of the guarantees and processing privileges which the respective public legal entity is empowered to confer. Transferring the competence to collect taxes to private legal entities does not constitute a delegation of powers.

LIMITATIONS ON THE POWER TO TAX

The power to tax is initially limited by the guarantees to taxpayers provided in Art. 150 of the Constitution. These individual guarantees prohibit the Federal Government, the States, the Federal District (Brasília) and the Municipalities from:

(1) demanding or increasing a tax not established by law;
(2) instituting differential treatment of taxpayers under equal situations; no distinction can be made based on professional occupation or function exercised, regardless of the legal denomination of the related earnings, titles or rights;
(3) collecting taxes:
  (a) which relate to taxable events which occurred before the law creating or increasing the tax entered into force;
  (b) in the same fiscal year as the law which created or increased the tax was published, with the following exceptions:
    (i) laws which create or increase taxes on:
      – imports
      – exports
      – manufactured products
      – credit, foreign exchange, insurance and securities transactions

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(ii) complementary law creating compulsory loans to meet extraordinary expenses arising from public calamity, foreign war or threat of foreign war;
(4) utilizing taxes for confiscation purposes;
(5) establishing restrictions on the transit of persons or property, by means of interstate or inter-municipal taxes, except for the collection of road tolls on highways maintained by the State;
(6) instituting taxes on:
(a) the assets, earnings or services of taxing authorities;
(b) any place of religious worship;
(c) the assets, earnings or services of political parties and their foundations, workers' trade unions, non-profit educational and social welfare institutions, provided all legal requirements are fulfilled;
(d) books, newspapers, magazines and the paper on which they are printed.

Item 6 lists cases of tax immunity. In the 6 paragraphs of Art. 150, the Constitution restricts the scope of such immunity in accordance with constitutional objectives, the aim of which is to only benefit the objectives of the State and the listed entities. Excluded from immunity are public services and economic activities which come within the jurisdiction of the regulations for private entities, and the activities of other entities which are not connected with the essential objectives of the State.

TAXES: ALLOCATION OF JURISDICTIONS

The Constitution allocates the levying of taxes between the 3 levels of government: the Federal Government, the State Governments including the Federal District (Brasília) and the Municipalities.

Under Art. 155, the Federal Government has exclusive jurisdiction to levy taxes on:
(1) import of foreign products;
(2) the export of locally manufactured or nationalized products;
(3) income and earnings;
(4) manufactured products;
(5) credit, foreign exchange, insurance and securities transactions;
(6) rural property;
(7) large fortunes.

The Federal Government may also (through supplementary laws) create taxes not foreseen under its exclusive jurisdiction, provided the taxes are non-cumulative and that the taxable events which gave rise to them or their calculation bases are not specified in the Constitution. The Federal Government may also create extraordinary taxes in the event of foreign war or threat of foreign war, regardless of whether such taxes are included in its jurisdictional powers. These taxes will be gradually eliminated once the reason for their introduction has ceased.

The States and the Federal District are empowered to levy the following taxes:
(1) taxes on gifts and inheritances;
(2) taxes on operations relating to the supply of merchandise and the rendering of interstate and inter-municipal transportation and communication services;
(3) taxes on the ownership of automobiles;
(4) an additional tax of up to 5% of taxes paid by individuals or corporate entities in the respective territories to the Federal Government as income tax on profits, earnings and capital gains.

Several matters should be noted with respect to State taxes. Art. 155, para. 2 of the Constitution establishes regulations for determining State legislative limits for the collection of value added sales tax and services tax. A new item which requires careful examination is the "additional" tax covered by Art. 155, item II. The Constitution provides that it is incumbent upon the States and the Federal District to institute an additional tax of up to 5% of the tax *paid* to the Federal Government as the tax established in Art. 153, item III. We highlight the word *paid* since the condition for payment of the additional tax is the effective payment of the tax described in Art. 153, item III of the Constitution.

Its calculation basis is that of income tax although it is not income tax. Income tax is a federal tax with which the additional tax should not be confused. The income tax *paid* is the event selected by the tax legislator as sufficient to determine the origin of the obligation to pay the additional tax and, consequently, to establish its calculation basis. Art. 153, item III, institutes income tax on income and benefits of any nature. The additional tax, however, is not due on all payments of income tax but only on the payment of income tax on profits, earnings and capital gains.

For the incidence of the additional tax, neither the interpreter nor the taxing authority can question whether or not income tax is due, nor judge whether or not the event supposedly leading to such tax being payable exists, nor can it question its calculation basis. State legislation cannot establish or alter the concept of income and benefits. The existence of a taxable event for (Federal) income tax purposes does not determine the occurrence of the State tax. This State tax, erroneously called additional income tax, is only due when income tax is paid. Thus, the taxable event for the additional tax does not occur until income tax is paid.

The individuals or corporate entities subject to the incidence of the "additional" income tax (Art. 155, item II) are those who, in their condition as taxpayers or as responsible for payment, pay the income tax. It should be noted that the source of payment is also deemed responsible for the additional tax payments and it has its own fiscal domicile (not necessarily the same as that of the company head office) as clarified in Art. 144, item II of the Income Tax Regulations.

According to the Constitution, the additional tax is payable to the federal unit (State or Federal District) in which the entity responsible for paying the income tax is domiciled.

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The laws which instituted the additional tax at each State level did not take into consideration some of the basic principles of the tax system nor did they uphold certain constitutional requirements to the extent required. This has led to a jurisdictional conflict which will probably only be resolved by a supplementary law – which normally would not be necessary – or by submitting such conflicts to the judiciary.

In some cases, State law erroneously presupposes that the entity responsible for payment is always the taxpayer, forgetting that the CTN establishes that the responsible entity can be the taxpayer as well as the source of payment. Other States have determined that the additional income tax is based on income tax *owed* rather than income tax paid. These laws apply a much broader interpretation to the constitutional rules. This is unacceptable primarily because the payment is a method of extinguishing the tax liability regulated by the CTN which does not permit a broad interpretation.

The Municipalities may levy taxes on:
(1) urban land and buildings;
(2) "inter vivos" transfers of any nature, for consideration, of real property and real property rights, except those offered in guarantee, as well as the assignment of acquisition rights;
(3) retail sales of liquid and gas fuels, with the exception of diesel oil; and
(4) services of any nature which are not under State jurisdiction.

Arts. 153-156 of the Constitution which list tax jurisdictions, also establish the basic rules regarding non-cumulative, selective and tax rate criteria, as well as the criterion for defining whether State or Municipal jurisdiction applies to transactions involving 2 or more States or Municipalities.

DISTRIBUTION OF TAX REVENUE

The following proceeds belong to the States, the Federal District and Municipalities: the proceeds from the collection of Federal income tax withheld at source on income of any nature of the respective political entity. Additionally, the States and the Federal District are entitled to 20% of the proceeds from the collection of taxes instituted by the Federal Government, as prescribed by Art. 154, item I, of the Constitution.

The Municipalities are entitled to the following proceeds:
- 50% of the proceeds from the collection of Federal taxes on rural property located in the respective Municipalities;
- 50% of the proceeds of the State tax on the ownership of automobiles licensed in the respective Municipalities; and
- 25% of the proceeds from the collection of value added sales tax on the supply of merchandise and services rendered.

The Federal Government must distribute 47% of the proceeds from the collection of Federal income taxes (excluding that part of withholding tax belonging to the States, Federal District or Municipalities) and excise taxes to the following Funds or Programs:

State and Federal District Participation Fund	21.5%
Municipal Participation Fund	22.5%
Financing programs for the productive sectors of the northern, north-eastern and central-western regions	3.0%
	47.0%

In addition the Federal Government must distribute 10% of the proceeds from the collection of excise tax to the States and the Federal District. This portion is distributed in proportion to the value of the respective exports of manufactured products, but no federal unit may receive more than 20% of the total amount. The excess is distributed among the remaining participants; the same proportional criterion is maintained. If one federal unit significantly exceeds the 20% limit, the constitutional criterion for apportionment could lead to absurd distortions since, during the division of the excess amount, the units which had exceeded the 20% limit would no longer be included in the apportionment. The States would deliver to the respective Municipalities 25% of the funds received on the apportionment of excise tax.

COMPULSORY LOANS

The compulsory loan is a type of tax. It includes all the essential elements for qualifying for the CTN concept of a tax. The need for restitution does not undermine this concept since the destination of the proceeds of the collected tax does not add to its judicial essence. This is established by the CTN:

> Article 4 – The specific judicial nature of a tax is determined by the taxable event of the respective obligation and may not be qualified by the following:
> I – the denomination and other formal characteristics adopted by law;
> II – the legal destination of the product of the tax collected.

Since compulsory loans are deemed to be taxes, they can take the form of any type of tax, such as taxes in general, rates or improvement levies, and can be recognized by application of Art. 4 of the CTN.

Art. 148 of the Constitution grants the Federal Government the exclusive jurisdiction to institute compulsory loans. However, this power is subject to certain conditions. Compulsory loans may only be instituted by complementary legislation to meet extraordinary expenses arising from public calamity, foreign war or threat of foreign war or in the case of urgent public investments of significant national interest.

CONTRIBUTIONS

Art. 14 provides that the Federal Government has the exclusive power to institute social contributions which will be used for professional or economic classes. The article's sole paragraph establishes that the States, the

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Federal District and the Municipalities may also create social contributions, but these must specifically relate to covering the costs of their social security and welfare systems for civil servants, and be collected from these employees.

Contributions are covered in the same chapter which establishes the national tax system's general principles and are subject to the constitutional limits imposed on taxes and the general rules in Art. 146, item III of the Constitution. Contributions may not be levied in the following circumstances:

(a) when they are not established by specific law;
(b) prior to the entering into force of the law which instituted or increased them; or
(c) in the same financial year in which the law which instituted or increased them was published.

The only exception to the last rule is social security contributions, as provided by Art. 195 of the Constitution. These may be charged 90 days after the date of publication of the law which instituted or increased them.

Contributions may have different purposes and differing methods of calculation. They can have the characteristics of a tax or a rate, or a combination of both categories or they can be contributions for given improvements. The taxable event of the respective obligation determines the specific nature of the contribution in each case (CTN, Art. 4). The Constitution refers to specific contributions in several provisions: social security contributions (Art. 195, 201-204); social contributions for education (Art. 212, para. 5); contributions to the Social Integration Program and to the Civil Servants' Patrimony Formation Program which finances unemployment insurance (Art. 239).

The growing powers of intervention of the State have further encouraged the creation of contributions and organizations which evolve and act alongside State functions (the so-called para-state functions).

Contributions, a State instrument for action and intervention, duly recognized as such by the Constitution in Art. 149, have one peculiar characteristic: the collecting entity is not necessarily the entity which retains the respective tax jurisdiction. As we have already seen, tax jurisdiction includes legislative jurisdiction (CTN Art. 6) which is held only by political entities, i.e. the Federal Government, the States and the Municipalities.

CTN, Art. 7 says that tax jurisdiction may not be delegated. Art. 7, however, does not mean that public bodies cannot pass on the following functions to other public bodies: collecting and monitoring taxes, executing laws and administrative acts. The passing on of functions provided in Art. 7 of the CTN does not authorize the entity to which such functions have been conferred to retain the proceeds of the tax collected which, however, may occur within the ambit of Financial Law. When the entity receives the functions provided in Art. 6 CTN and, furthermore, has the availability to use the amounts collected for the execution of its own specific activities (as occurs, for example, in the case of INPS (Social Security) contributions, the highway toll charged by DERSA (the official highway board), the contributions charged by the Brazilian Bar Association (OAB)), we have the phenomenon known as para-fiscal taxes. These para-fiscal taxes are subordinate to the legal/constitutional tax jurisdiction. The legal destination of the proceeds from tax collection is not relevant for the specific judicial qualification of the tax, as established by Art. 4 of the CTN.

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BRAZIL:

The New Income Tax and the Treaties to Prevent Double Taxation

Eivany Antonio da Silva

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The income tax, from the time it was first introduced in Brazil, has always been based on models developed abroad, primarily those systems used in developed countries. In recent years this trend has been emphasized by the strengthening of the schedular system of taxation and increasing the number of brackets in the tax rate schedule. Previously, the schedules included up to 9 classes of net taxable income and the rates went up to 50%.

There has been a significant increase in the number of items allowable to adjust gross income or allowable as itemized deductions. The first group increased because of various expenses incurred which are deemed necessary for the receipt of income from the sources defined in the income tax legislation. The number of itemized deductions increased because they are considered necessary expenses for the maintenance of the taxpayer.[1]

The demand for the adjustment of gross income and the several schedules together with the itemized deductions required more sophisticated arrangements which necessitated increasingly complex legislation each year which in turn forced taxpayers to commit additional time and effort to fulfill fiscal obligations.

For these reasons, Brazilian income tax legislation became comparable, in terms of technical complexity, to that of the United States, Canada, Japan and several of the major European countries. Certain circumstances, however, precluded the technical level of sophistication of the Brazilian tax legislation from maintaining pace with the understanding of the average Brazilian taxpayer. In addition, statistical evidence on individual income taxpayers showed that 61% of all taxpayers accounted for only 3% of the revenue collected. In other words, the cost of collecting the revenue increased disproportionately to the revenue return.[2]

Ideally, individuals engaging in any economic activity should pay a share of the income tax because all individuals benefit from State services which are financed from funds raised through taxation. However, the degree of income concentration in Brazil is so severe (or in other words, income in Brazil is so poorly distributed) that out of a total of 45 million economically active individuals only 3.2 million earn sufficient income to enable them to pay an income tax without undue personal sacrifice.

On the other hand, the theory of progressivity of income tax as articulated by the concept that those who earn more should pay a larger share of tax (based on reasons commonly termed horizontal and vertical equity) is beginning to be challenged worldwide. For example, under the 1986 U.S. income tax reform, which reduced the number of tax rates to 2, progressivity was transformed into proportionality, beginning at a certain level of income. The overall taxable base, however, was increased either by eliminating or reducing adjustments and deductions.

In Brazil, either because of the small number of taxpayers or because the income tax maintained a reasonable rate of progressivity, the income tax reform affecting individual income taxpayers appears reasonable and consistent.[3] Considering the various problems attending Brazil's individual income tax system, the 1988 tax reform aimed to achieve the following basic goals:

(a) simplification of the rules governing individual income taxation;
(b) reduction in the tax burden for labour income and simultaneously increasing the fairness of the system; and
(c) equal fiscal treatment of income from labour and capital.

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1. In recent years, however, certain tax incentives were introduced for these types of deductions (e.g. payments made to private social security groups and cash contributions made for the furtherance of cultural activities).
2. To further illustrate this point, the same revenue figures show that out of a global number of 8 million taxpayers, 40% or 3.2 million individuals paid 97% of total revenue collected through individual income tax.
3. The reform was introduced by Law 7,713 of 1988, in effect from 1 January 1989.

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Although the Brazilian individual income tax reform contains some unique features, the reform in general follows the trend of similar reforms introduced in other countries. It reduces the number of rates in the overall individual income tax rate schedule and increases the aggregate amount of income subject to taxation by the elimination or reduction of adjustments and deductions.

The 1988 tax reform duly considered the global tax principles laid down in Brazil's new Constitution. In fact the new Constitution reinstated the general principle that any tax levied in Brazil shall take into account the paying capacity of the taxpayer, i.e. in order for an individual to pay tax he must have the economic capacity to do so. The new Constitution also requires that all taxes have universal application and be of a progressive nature. The tax reform complies with the isonomy principle which prohibits unequal tax treatment of individuals under the same conditions. Any distinction based on differences of professions or because of the legal denomination of any income is also prohibited.

As of January 1989, individual income tax is due on a monthly basis at the same pace as income is earned. In this way, the pay-as-you-earn system (PAYE) is fully introduced in Brazil. Previous attempts to implement a PAYE system were unsuccessful because of revenue erosions due to the effects of inflation. In periods of high inflation, the gap between the time income is earned and the time income tax is paid increasingly reduces the tax burden. The old system resulted in unequal tax treatment of salary and wage earners because they already were subject to a monthly payment through withholding at source, therefore carrying a tax burden heavier than that carried by taxpayers paying tax on an annual basis. This was particularly true for taxpayers earning income from capital or income derived from the sale of immovable property. The introduction of the monthly payment of the individual income tax for all taxpayers is fully justified because taxpayers in different situations and earning the same monthly income may no longer use inflation to reduce their tax burden.

The central issue of the Brazilian tax reform was the reduction of the 8 tax rates to the present 2 rates of 10% and 25%. To make the new system of lower taxation consistent with the revenue requirements of the public sector, all adjustments to gross income and almost all deductions have been eliminated.

Henceforth, income tax will be calculated on gross income without any adjustment (with the exclusion of special cases for certain deductions provided by law). The adjustments were eliminated to simplify the tax legislation as a whole. Any exception to the prohibition of adjustments to gross income would jeopardize the reform's basic goal of simplification because adjustments to gross income and itemized deductions require checking mechanisms which necessarily compound the complexities of tax legislation. The tax reform, from the first draft, intended to abolish most if not all of the complex administrative red tape for the majority of taxpayers.

To make the elimination of adjustments and deductions consistent with the goal of effectively reducing the tax burden, limits for exemption from taxation were introduced: one limit for taxpayers with income subject to the 10% rate and another for taxpayers with income subject to the 25% rate. These limits were originally given in OTNs (National Treasury Bonds). Subsequently, however, because of the introduction of legislation abolishing the indexation widely adopted by most sectors of the economy, the values for the exemption limits were converted into new cruzados. The OTN value for 15 January 1989 was used for the conversion.

In line with the prescription of the new Constitution (i.e. universal application and progressivity as basic requirements), the income tax reform was careful to increase the total amount of income subject to taxation (expansion of the overall tax base) and maintain a certain rate of progressivity within the new system.

The generality criterion for the tax law necessitated repeal of many tax exemptions granted by the old system, in particular exemptions for certain categories of professions. The universal application criterion mandated that all income derived from any profitable activity should be subject to income tax, and progressivity was retained by the introduction of 2 tax rates and the admission of the exemption limits.

Nevertheless, some income continues to be exempt from taxation. Although the universality principle recommends taxation of all income, this principle should not prevent certain income from being treated differently, because a strictly equal tax treatment of all income would jeopardize taking the taxpayer's individual capacity to pay tax into consideration. The new system maintains payments made by the taxpayer to a former spouse and children as itemized deductions. These payments are to be declared as taxable income by the recipients. Expenses for health care amounting to more than 5% of gross income are also deductible, but limited to 5 persons.[4]

The taxation of capital gains, a new source of revenue for the national Treasury, will strengthen the income tax, expanding it as an effective instrument for income redistribution. Capital gains taxation, already widely used in most countries, previously only applied to a small portion of capital gains; this disadvantaged labour income which was fully taxed at source. Capital gains, when not undertaxed, were wholly exempt from taxation. For example, in determining the taxable base of gains derived from immovable property, the monetary correction of the cost of the property was taken into account and the law allowed a 5 percentage point reduction of taxable income so obtained for each full fiscal year the taxpayer held the property. In this way, all immovable property held for 20 years or more was

4. Individuals living at the expense of the taxpayer (such as a nonworking spouse, children and adopted children) are also covered. In addition, a certain amount per person is also deductible.

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fully exempt from income taxation. In addition, when a taxpayer made a taxable gain he had the option either to have such income taxed at a flat rate of 25% or add it to his other income and have it subject to the normal progressive tax rate schedule. In practice, this system always resulted in a lower than normal taxation to high income taxpayers earning capital gains, when compared to the effective tax rate paid by taxpayers with income mandatorily subject to the progressive income tax rates. In addition to these advantages, the tax, when paid at all, was only due in the year after that in which the property was sold. This further reduced the effective tax rate to the taxpayer because of the high inflation rate. In accordance with the new tax law, from 1989, all income and capital gains derived from the sale of immovable property and various other rights will be subject to the normal rates of income tax applicable to all individuals.

The above changes do not specifically relate to the tax treaties Brazil has signed with several countries or with those treaties Brazil will sign in the future. Under tax treaties, the tax treatment of dividends under the tax reform must be compared with relevant provisions of existing tax treaties.

Arts. 36, 37 and 38 of Law 7,713/88, in line with the simplification of tax law aimed at by the reform, lay down the rules to measure the increase in assets held by partners and shareholders when the outcome of a year's commercial activity is ascertained at the end of a taxable year. The increase in the value of assets will be the base to levy the new tax. The new law provides for an income tax of 8% to be calculated on net profits determined in accordance with commercial laws and adjusted for non-deductible allowances and due compensation made for accounting losses incurred in past taxable years. This income tax will be the sole income tax due on such income when the beneficial earner of the income is an individual resident in Brazil. The tax may be credited against other income tax on profits when the beneficial earner of the income is a non-individual income taxpayer residing in Brazil. All taxpayers residing abroad will credit this tax against the income tax due when a dividend is distributed; an immune or exempt partner or shareholder is not subject to this tax.

The taxation of branches of foreign companies is not affected by the new tax because the profits of these branches are already fully taxed under the old system and because its owners are residents abroad.

This new form of taxing dividends aims to integrate the income tax of corporations and the income tax of non-individual income taxpayers with that of individual income taxpayers. In fact, the shareholder will ultimately shoulder the entire income tax burden, including the income tax paid at the corporate level. Because of the size of the tax burden it appears that corporations use various means to bypass some of that burden, either using borrowed capital, interest of which is deductible as a cost while dividends are not, or distribution of profits, in some instances through disguised and generally illegal forms (by way of so-called fringe benefits, etc.). All such practices are difficult to detect. The taxation of dividends at the new present low rate may make income tax a neutral factor in relation to establishing a company's dividend distribution policies.

Finally, I must add that although the new law provided for this important change in the taxation of dividends, no change has been introduced in the final rate of income tax applicable to dividends attributable to residents abroad.

Considering the goals envisaged by the income tax changes (for instance, the reduction of the overall tax burden to the shareholder receiving the dividend), one question remains: will the rules in Brazil's double taxation agreements apply to dividends remitted abroad? This question arises because until 1988 income from profits or dividends derived by a partner or shareholder resident or domiciled abroad were subject to taxation only when remitted, credited or paid to such partner or shareholder. In the absence of a treaty, the applicable rate is 25% for payments to residents abroad; in the case of a treaty, the rate is set forth therein. Finally, if there is a difference in the tax treatment of partners and shareholders residing outside Brazil, is the different tax treatment consistent with the nondiscrimination clause present in all Brazil's tax treaties?

Let me first try to answer the question related to the tax treatment of profits and dividends of partners and/or shareholders resident abroad.

First of all let us say that there is a difference affecting these taxpayers under the new income tax law when compared to their tax treatment under the old law, i.e. now 8% income tax is calculated on profits or dividends once a net profit has been determined; under the old law no such income tax was due at that time. This aspect of the tax treatment of partners and shareholders residing abroad applies equally to all partners and shareholders residing in Brazil.

Since all partners and shareholders are subject to the new income tax and there has been no change in the rates applicable to income remitted to residents abroad, how will the new tax be treated so that the taxpayer continues to pay the same percentage of his income in the form of income tax as he paid before the introduction of the new income tax law? Some additional administrative controls may result but any recipient of profits or dividends residing abroad will pay exactly the same percentage of his income in the form of income tax as he paid before the introduction of the 1988 tax reform.

Let us discuss a small example to clarify the issue.

Old system

Dividend (no treaty)	100 cruzados
Withholding tax at source (25%)	25 cruzados
To be remitted abroad	75 cruzados

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New system

Dividend	100 cruzados
A credit already exists at the time a dividend is declared	8 cruzados
	92 cruzados
Gross income tax upon declaration of dividend 25 cruzados	
Net income tax	17 cruzados
To be remitted abroad to partner or shareholder	75 cruzados

Now let us turn to the second question. Thus far it has been admitted that partners and shareholders residing in Brazil receive a different tax treatment under the new law than partners or shareholders (even the same partners or shareholders in a subsequent tax year) residing outside Brazil. How can such different tax treatment be reconciled with the nondiscrimination rules applicable to nationals of Brazil and nationals of a Contracting State, as provided in all of Brazil's tax treaties?

The nondiscrimination principle as stated in Brazil's tax treaties reads as follows: "The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected".

The nondiscrimination principle as stated above can only be extended to 3 situations affecting taxpayers in the Contracting States. In all 3 situations, both taxpayers are "in the same circumstances". Brazil's new tax law covers all possibilities under the nondiscrimination principle. As an example, we will consider the tax treatment of a hypothetical Brazilian taxpayer and a treaty partner's taxpayer where: (a) both taxpayers reside in Brazil; (b) both taxpayers reside in the other Contracting State; and (c) both taxpayers reside in a third country which is not a tax treaty partner of Brazil.

Some taxpayers have tried to interpret the nondiscrimination article in such a way so as to extend its application to cases where the treaty partner's taxpayer is not present in Brazil. But how can this particular interpretation be reconciled with the requirement that both taxpayers should be "in the same circumstances" when the text of the clause always refers carefully to "nationals" and not to the type or source of taxable income? The "circumstances" in this particular instance appear to be clearly addressed to the nationality of the taxpayer, therefore aiming to prevent different tax treatment for reasons of nationality only.

Returning to the situations in which the application of the nondiscrimination clause appears to be valid, consistent and unchallengeable, let us see how the taxpayers will be treated under the new law and whether there is any difference in the treatment of a Brazilian taxpayer and a taxpayer or a national of a treaty partner country. In the first case presented, both taxpayers are residents of Brazil. Under the new law, both taxpayers would be subject to the new 8% income tax. This would also be the maximum tax burden for such income for both taxpayers, resulting in an even lower rate than the rate provided for in the tax treaties. Because the tax treatment in this first case is equal for both taxpayers, the new tax law is consistent with the nondiscrimination clause as drafted in Brazil's tax treaties.

Now let us see the outcome of the tax treatment under the new law when applied to the second case, i.e. when both taxpayers reside in the other country. In this case, both taxpayers will be subject to the 8% income tax due at the moment the profit is determined and, upon declaration of the dividend, the difference between the rate provided for in the tax treaty (normally 15% for Brazil) and the tax of 8% already paid. The difference, assuming a 15% treaty tax rate, would be 7%. In this second case, again, the new law treats both taxpayers equally. The new law is consistent with the nondiscrimination clause as provided in Brazil's tax treaties.

Finally, the third case where both taxpayers reside in a non-treaty partner country: under the new law, both taxpayers will be subject to the initial 8% income tax due at the moment the profit is made. The final tax burden for both taxpayers is the normal 25% rate, applicable, in general, to all income remitted to taxpayers residing outside Brazil. The new law does not cause any different tax treatment for the national of the treaty partner country and therefore the new law, in this respect, is definitely consistent with the nondiscrimination rules of Brazil's tax treaties.

Before concluding, I would like to mention that in the area of international taxation and in some tax treaties there are clauses prohibiting the taxation of undistributed profits. Brazil's tax treaties contain no such provisions. The only reference to limitation of taxation is related to dividends and appears in the article dealing with dividends. This provision refers only to the extraterritorial aspects of attributing profits to a particular establishment with which the generation of such profits is wholly unrelated.

CONCLUDING COMMENTS

Now that I have concluded the discussion of Brazil's 1988 income tax reform and its neutrality to existing tax treaties, let me briefly consider whether the tax reform will have any impact on the investment environment in Brazil considered from the point of view of taxation.

Taxation naturally plays a significant role in composing the global investment environment of any particular country at any specific period in history. Furthermore, tax policy designers, when intending to promote investment in the domestic economy, naturally have to be aware of the policies being implemented in other economies in a worldwide competition to attract the limited and elusive capital resources available for productive investment. Each country is free to design the

[continued on page 407]

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BRAZIL:

Inflation and Taxation

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INTRODUCTION

One of the most conspicuous traits of Brazil's developmental process is the chronic inflation which has been unsuccessfully combatted by repeated economic shocks. Strictly speaking, I believe that no meaningful attempt to grapple with the true causes of inflation has ever been made in Brazil. As a result, the economic measures introduced over the years have always failed, bearing out the expectations of those who understand the real phenomenon.[1] It is generally agreed that the main obstacle to quick recovery is the inflation attributed to flawed ministerial "solutions". These solutions are designed to combat inflationary effects (price controls) rather than inflationary causes (growth in the money supply generated by public spending).

Insofar as the national reality has become Brazil's resignation to living with rampant inflation, the economic structure as a whole is directly linked to the struggle of finding the correct index numbers which will permit the precarious relations between private and public law (including those of tax policy) to be kept pat.[2]

In this article I intend to reveal the real reason for Brazil's inflation, to propose the ideal formula to combat it and to analyze the legal mechanisms which allow inflation to be placed under legal regulation. In this fashion, I hope to deal with both facets of the issue suggested by the organizers of the "Digest":[3] examining Brazilian inflation as well as the tax policy adopted by our country to conform to the situation.

REASONS FOR INFLATION[4]

Brazilian inflation is not spurred by demand, costs or imports; it is not inert or the result of social well-being, although at times it may have taken on any one of these guises. Rather, Brazilian inflation is fundamentally official. The State spends more than it should and its public debt necessarily generates a swelling monetary base and money supply, brought on by unrestrained issuing of money.[5] The outcome is that the country's thwarted tax and monetary policy becomes an ongoing fueling agent of the inflationary process.[6]

COMBATTING INFLATION

Two basic positions have been advanced as to how the public debt should be dealt with, i.e. eliminating it by reducing expenses or eliminating it by increasing revenues.

1. The International Academy of Law and Economics and the São Paulo Commercial Association dedicated issue No. 333 of the "Digesto Econômico" magazine to publishing prognosticative studies on the nation, entitled "A Project for Brazil". The following individuals contributed: Ives Gandra da Silva Martins, Carlos Alberto Longo, Cassio Mesquita Barros, Gilberto de Ulhôa Canto, Theophilo de Azeredo Santos, Alberto Zavier, Benedicto Ferri de Barros and Diogo Leite de Campos.
2. Arnold Wald, *Monetary Correction in Brazilian Law*, Ed. Saraiva (1983) at 23 justifies indexation of the economy in these words:
"62. But when there is inflation, monetary correction imposes itself to prevent the law from swaying us to commit injustices in the name of a principle we do not believe in, which is the illusion and the pretension of there existing any stability in the purchasing power of currency, nowhere mentioned in the Constitution or the laws. Much to the contrary, the Federal Constitution itself recognizes the existence of changes in the purchasing power of currency.
63. Let not justice be sacrificed to myths, especially to outdated myths.
64. Law is not a blind mechanism that can be used to purely economic ends. To the contrary. It is an instrument inspired on an ethical purpose and intended to fulfill it. Now, therefore, monetary correction, in all reality, corresponds to an ethical imperative based on the good faith of the parties and on the respect of their true will.
65. The monetary correction clause is not that injection of morphine which some authors refer to. It is a major remedy for major disorders, just like penicillin and cortisone, whose negative aspects manifest in certain cases do not justify not using it to save lives in most cases. It is the case of a remedy which jurists, administrators and businessmen must be well-acquainted with and know how to use, and which requires systematic treatment, since it is a technique by which the law can adapt to reality and thus avoid the "revolt of the facts against the law."
3. See footnote 1.
4. In 1983, Gilberto de Ulhôa Canto, J. van Hoorn Jr. and I prepared a book for the International Bureau of Fiscal Documentation in which we analyzed the indexation mechanisms adopted in Brazil to live with inflation. We studied both the consequences and the causes of inflation, demonstrating that Brazil had been more enterprising in fighting the consequences, by introducing monetary correction, than the cause. Nonetheless, we did not hide the fact that although it would be easier to battle the cause rather than the consequences, this tack would require more than mere technical macroeconomics; it would

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Despite the fact that most economists in Brazil endorse the most appropriate solution, i.e. reducing expenses, primarily in the area of costs[7], all administrations have adopted formulas which attempt to combat the public debt by increasing revenues, particularly taxes.

Those who defend the idea of increasing revenues to cover the deficit (because this is easier than reducing expenses and slowing down the administrative machine) and argue that such an approach is not inflationary and does not hinder development, are forgetting something. In their view, since money ends by circulating and replenishing government coffers, the State does not need to issue more money. They forget that inasmuch as an increase in revenues requires a further levying of taxes, it necessarily and immediately brings about a general increase in the private cost of goods and services because these prices are necessarily passed on to the consumer. The circulation of money, however, does not represent development because the way the money is used can be more or less productive depending on how well or poorly it is invested.[8] In other words, there are productive and non-productive ways of spending money; an examination of global economic policy demonstrates that the more the size and expenses of the State are reduced, the more space the private sector has to act creatively and efficiently, particularly when the private sector is encouraged by non-punitive tax policies and stable monetary policies.

Unfortunately, Brazil has chosen to fight the public debt by increasing revenues, thus creating a climate of unrest and insecurity for investments. This, in turn, has created an unstable monetary policy which cannot ensure protection for mid and long-term financial investments. The federal government will not reduce its expenses (although it publicly recognizes the immense waste in official expenditures), or reduce the size of its administrative machine and the number of its public employees.[9] Consequently, the more inflation is tackled incorrectly by increasing revenues, the more inflation increases, creating an unstable savings and investments climate. This climate devastates development and this is clearly the wrong formula to combat inflation.

Added to the climate created by an inappropriate inflation-checking technique is the form of government adopted by Brazil, i.e. the Federation. The Federation is a more burdensome form of government for the citizen than the unitary State. In a unitary State, only one political cost is borne by society, whereas in every Federation which has so far existed this cost is doubled. The 2 orbits around which sovereign governments revolve (central power and states, or provinces) impose a heavier burden on the community which they represent.

In most Federations, however, the greatest cost of the State is offset by its diminished presence in the economy. By renouncing entrepreneurial activities (for which the State has no vocation), the State receives more revenue to perform its legitimate vocation, i.e. administering justice, ensuring domestic and foreign security, and creating systems of education, health, social assistance and social security, rather than creating and providing mechanisms to fight abusive economic power.

Forsaking the role of entrepreneur, in which its performance has always been poor, the State refrains from spending in areas in which it lacks expertise and spends where it has expertise. In resigning from its role as entrepreneur, the State becomes the privileged partner of the business companies (through taxation) but without the task of management.

Normally, in developed countries the Federation's greatest political cost is offset by slight government interference in the economy; therefore public administration does not generate inflationary deficits. The Brazilian Federation is atypical. The Brazilian Federation has 3 levels of autonomous governments (Federal, State and Municipal); to this must be added the indebted Entrepreneur-State, the largest presence of its kind in any Federation in the world. The Brazilian Federation is, consequently, by necessity, inflationary. The entrepreneurial nature of the 3 levels of government and the autonomous federative entities impose high costs on society. The heavy burden caused by the government's barely tolerable performance is imposed on the private citizen, thus discouraging production, investment and savings because government operations are inefficient due to its size.

The new configuration of the Federation as shaped by the Constitution recognizes the State as entrepreneur, granting it larger monopoly powers, intervention, and market reserve areas.[10] To compensate for the expansion of an already oversized State, it is necessary to create new forms of tax for the 3 levels of government, the taxes to be borne by the same citizen and by the same society.

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require sacrifice and political willingness. The book was entitled *Monetary Indexation in Brazil,* International Bureau of Fiscal Documentation, Amsterdam (1983), No. 34. Contributing authors included: Roberto de Oliveira Campos, Raphael Bernardo d'Almeida Jr., Ives Gandra da Silva Martins, Henry Tilbery, Bernardo Ribeiro de Moraes, Geraldo de Camargo Vidigal, Cassio Mesquita Barros Jr., Ada Pellegrini Grinover and Mauro Brandão Lopes.

5. It is widely recognized by all economists in Brazil that the actual cause of inflation is the public debt. Even the government recognizes the truth of this assertion.

6. Interestingly enough, Art. 164 of the Brazilian Constitution prohibits this: "The competence for issuing money falls solely under the Central Bank.
Para. 1. The Central Bank is not authorized to grant loans directly or indirectly to the National Treasury nor any other agency or entity which is not a financial institution".
Notwithstanding, the Federal Government has not complied with the provisions of the Magna Charter since its enactment.

7. Expenses can also be reduced in the area of investments when these are superfluous and poorly directed.

8. For a discussion see Da Silva Martins, *The New Idle Class* (ed. Forense, (1987)).

9. On the federal level alone, one million employees have been found – by technicians of the government itself – to be unnecessary.

10. The Federation is also larger because the Constitution has granted tenure to civil servants who have not taken or passed service examinations, it increased the number of judges, courts and congressmen, expanded social benefits, etc.

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Under the new Constitution, the country must have a high tax burden level – 25% to 30% of the GNP – until the end of 1989. With regard to the make-up of the GNP, the Brazilian State rarely pays taxes and yet it accounts for more than 50% of GNP (statistics vary between 50% and 66%). However, in reality the private sector (businessmen, employees and professionals) bear a tax burden of approximately two-thirds of what they produce, paying the highest tax in the civilized world and receiving in exchange the worst public services because of the top-heavy Federation. Therefore, the private sector's only protection is to immediately pass on this excessive burden to its customer. Doing so, however, contributes to the vicious circle that is impossible to combat until its origin, the public debt, is eliminated.

At the end of December 1988, the federal public debt reached the frightening percentage of 38% of the GDP, unmistakable evidence that it cannot be controlled by increasing government revenue, but rather only by a process that has never been utilized in Brazil, the reduction of expenses.

With this scenario, one can see that inflation is constantly explosive. The government maintains a policy of high interest rates to avoid the dollarization of the economy. However, it does not combat inflation; it only generates it because consumption is already inhibited by stagnating production, instability of economic rules, and constant changes in exchange, monetary and taxation policies. The policy of high interest rates – whose purpose is more to avoid the flight of capital than to combat an inflation of non-existent demand[11] – instead generates an excess of liquidity and profit, increasing the pressure on the federal public debt.

For this reason, the successive economic shocks fail as the Government uses artificial freezes to contain price explosions. However, the government does not hold back salary, tax and tariff increases. Instead it generates inflation, shortages, relative price distortion, and the parallel market. It must stop freezing prices so that future inflation will absorb the losses deriving from past inflation.[12]

I believe that if the government intends to combat inflation it will have to begin by cutting expenses. The cut will need to be drastic and will conflict with various interests, particularly political interests. The government will have to renounce the present system of indexation, maintain high interest rates, not spend more than it takes in, and allow market rules to adapt the country to a new phase, even though the new phase may be a harsh depression. Such is the price to be paid for past errors.

When the rules of the market are established and the Central Bank becomes truly autonomous and has strict control over the currency, it will be possible to recommence the process of development. Brazil is a nation that is well-equipped for all types of investment, i.e. it possesses all the natural resources needed by the economy, it is self-sufficient in agriculture and industrial production, and has technology which is quite developed.

Once internal stability is achieved, the problem of the foreign debt will be solved by means of longer terms of payment, reduction of interest, and the transformation of risk capital, thus offsetting the inflationary impact of conversion by a substantial reduction in government spending.[13] This is the only way that the Brazilian inflation phenomenon can be controlled effectively.

LEGAL REGULATION OF INFLATION

Inflation, then, will continue so long as its actual cause is not combatted. Such a course of action does not seem feasible in the short term. Faced by this reality, the Brazilian economy has been indexed. The 2 attempts to remove indexation (the Cruzado Plan and the Summer Plan) were defeated by the facts. The OTN (National Treasury Bond) indicator, paralyzed from March 1986 to February 1987, leaped 71% when it was freed. From that time until January 1989, it climbed at a vicious rate showing an inflation rate of 365% for 1987 and 935% for 1988.

In tax matters, all fiscal debt was tied to the OTN, which until that date, absorbed the inflation of the month.

Payments to the 3 levels of government, i.e. the Federal, the State and the Municipalities, were based on the OTN. As required by statute, the Federal Government introduced the fiscal OTN, a daily indicator, to encourage taxpayers from delaying payment while they invested in the best opportunities the financial market offered within the month. This attempt to control the course money was taking created the "feed back effect of indexation".

The Brazilian tax system today is composed of 15 taxes, duties, special contributions, contributions for improvements and compulsory loans. Brazil imposes approximately 50 different types of taxes which make every citizen (who pays 2/3 of his income to support the triplicate administrative machinery) more of a producer of taxes than an actual producer of products. Of the 15 taxes, 7 belong to the Republic: the tax on industrialized products, import tax, export tax, tax on financial transactions and (all) taxes on income, large fortunes and rural properties. Of these, only the tax on large fortunes still awaits legislative regulations.

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11. The government thinks that Brazilian inflation is a "demand inflation" because the people buy excessively and consequently the level of prices are high. This is not true. We do not have any demand explosion which is why I use the term "an inflation of non-existent demand".
12. Robert L. Schuettinger, *Forty Centuries of Wage and Price Controls: How Not to Fight Inflation* (The Heritage Foundation (1979) demonstrated that since the time of Hammurabi it has been known that inflation cannot be fought by means of its effects (price control), but by means of its cause (control of expenses)).
13. If we can change the external liabilities of risk capital, the Brazilian Government will naturally be obliged to give "cruzados" to foreign investors to invest in Brazil and the effect will be inflationary. The only method of reducing this effect is to reduce government spending in other areas. The possible increase of monetary expansion by the conversion would be counter-balanced by this type of reduction in public spending.

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Until 15 January 1989 all of these taxes received full monetary correction. If the payment was made on the specified date, the nominal value of the tax was paid. In the case of delay or the legal right to defer payment, the index ratio, linked to the OTN (monthly indexation) or to the fiscal OTN (daily indexation) was applied.

Income tax, however, merited a special approach. When, in 1984, I participated in a panel discussion on "Fiscal adjustments in countries with high inflation", during the IFA Congress in Buenos Aires, I emphasized the Brazilian legal regime for coexistence with inflation. At the time, the individual income tax system was being placed on a current basis in an attempt to counter the prejudicial effects of inflation on individual tax collection.

This occurred effectively when Law 7450/85 was adopted and finally, with Law 7713/87.[14] In fact, under Law 7713/88, all types of income were taxed on the basis of the calculation of their base value in OTNs, which meant that the tax would be collected by virtue of the indexing mechanism. The taxpayer was allowed to pay the nominal value of the tax in the first days of the fortnight following receipt of the income or an amount of tax indexed by OTNs calculated on the annual income results on the date of the payment of the difference between the tax retained by the employers and that owed by the taxpayer, determined by the sum total of his earnings deriving from labor, capital or capital gains.

Regarding corporate entities[15], Brazil had already adopted systems which allowed the company to calculate profit or loss with inflation, so that whenever the permanent assets showed indexed values inferior to the stockholder's assets, the company's loss taking into account inflation would be deductible from the profit calculated. Should the reverse situation occur, the company's profit taking into account inflation would be added to the operational or eventual profit, it being possible, however, to defer payment charges of the income tax on profit until the moment of its realization/conversion into money. This solution was adopted in order to avoid the company's decapitalization.

Decree Law 2241/87 on inflationary profit, however, reduced the deferment of the tax payment to only 95%, a 5% profit being automatically considered.

All taxes on corporate entities were already calculated, at the time, in OTNs, in such a way that the payment in the months established by law according to the type of corporation would not result in a loss to the Treasury.

Therefore, the federal legislation was adapted to the inflationary phenomenon, including that which concerns indirect taxes, with the Revenue anticipating their collection. Sometimes such anticipation took place prior to the liquidation of the respective operation, which meant that the taxpayer was obliged to pay the tax before receiving the full price of the merchandise from third parties, the anticipated taxation was already included and would end by adding a projected inflation which accelerated the inflationary process.

In the States that now have 4 taxes (taxes on gifts and inheritances, taxes on transactions involving the circulation of merchandise, taxes on the ownership of automobiles, and an additional tax of up to 5% of taxes paid on profits, earnings and capital gains), the dynamics of the updating of the fiscal debits followed, until 15 January 1989, the variation of the OTNs, in such a way that the compensation mechanisms against inflation were also adopted, without, however, the sophistication of the daily OTNs.[16]

The Municipalities, of which there are almost 5,000 in Brazil, collect taxes on services, taxes on real estate transactions, taxes on liquid and gaseous fuel and on urban property. When their share of the revenues was smaller, they adopted the monthly OTNs for the indexation of their taxes paid without the allotted time span.[17]

This situation, however, was radically altered by the Medida Provisoria (Temporary Measure) No. 32, of 15 January 1989[18], when the Government cancelled the indexation of the entire national economy, intending to fight inflation by: (1) the removal of indexation; (2) severe fiscal and monetary policies and a drastic cut in public expenses with the reduction of the Ministries, dismissal of employees and privatization; and (3) high interest rates to inhibit consumption.[19]

In a failed effort to gain popularity, the President of the Republic introduced, once again, a "price freeze policy" and controlled prices, upsetting, with that measure, the relative prices. In the sequence established, he did not cut down needless expenses nor did he make a head count of Government employees. The promised privatizations did not occur, and 2 weeks later indexation was reintroduced, and the policy of high interest rates maintained. The price freeze policy was maintained only until mid-April, notwithstanding the "defreezing" of salaries and the increase of public prices, plus a high issue of currency, contrary to promises.[20] It immediately became apparent that the opportunity to fight inflation had once again been lost. Inflation, in Brazil, has once more begun its corrosive upwards trend.

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14. Law 7450/85 was the first attempt to adopt the "current basis system" in the income tax. In times of inflation (in spite of indexation), the delay in paying income tax on a preceding year basis creates serious problems. Consequently, Congress tried to introduce a system which reduces the delay between the acquisition of income and the payment of income tax.
15. This was the main subject of discussion at the IFA Congress.
16. The Federal Government received this tax credit with a daily indexor and the States with a monthly indexor. This is the reason the States lose more with inflation than the Federal Government.
17. This was the case even though the Municipalities have less taxation powers, i.e. they adopted the monthly rather than the daily indexation.
18. The Medida Provisoria (Temporary Measure) as transformed into Law 7730/89.
19. This advice was offered to the Government by some of the most respected Brazilian economists, amongst whom we can name Octavio Gouveia de Bulhões and Mario Henrique Simonsen.
20. The reintroduction of indexation came about with Medida Provisoria No. 38 and, at the time this article was written, there were already 44 temporary measures, published since 10 October 1988, when the new

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The Government, with the reindexation of the economy and taxes, has started to feed on the anticipation of inflation, generating more inflation by the anticipation of the taxes.

The IPC (Indice de Preços ao Consumidor – Index of Consumer Prices), based on the value of the last OTN which was adopted by the Government as a new index, ran into the notorious challenge of unconstitutionality relative to the income tax charged the previous year, despite the fact that the reintroduction of the monetary correction in the same fiscal year contravenes Art. 50, clause III,"b" of the Constitution, which reproduces Art. 153, para. 29 of the former Constitution. The Supreme Court had already given its decree on such unconstitutionality in the past, which leads me to believe that it will not be different this time. Companies not agreeing with unconstitutional demands have resorted to legal measures to avoid paying the monetary correction re-introduced in the same fiscal year by the Medida Provisoria No. 38.[21]

The Brazilian States, however, did not feel sufficiently protected by the new indexes and decided to adopt different criteria, i.e. to measure inflation by the former criteria (OTN) and not by the IPC. As a consequence, at the time of writing this paper (April 1989), the taxpayer lives with several different inflation indexes in terms of tax laws, which makes living with inflation extremely complex. In May, in view of the return of the inflationary process which has already started with the same momentum and intensity as the previous "economic shocks", a uniformity of the index ratio is predicted. This new index ratio is the BTN (Bonus do Tesouro Nacional – Note on the National Treasury) and substitutes the OTN (Obrigação do Tesouro Nacional – Obligation on the National Treasury).

CONCLUSION

As I initially stated, it is easier to fight the effects of inflation[22] than to fight inflation itself, as the effective political will to combat inflation is lacking and may, perhaps, only be present at the end of 1989, after the Presidential election. In spite of the challenges of inconstitutionality, the indexation system is like insulin for diabetics, allowing them to live with the disease, but not curing the disease itself. I hope that one day there will be the possibility of fighting the disease, as the patient is strong and as the medicine (does) exist. One has only to want to use it.

Constitution was instituted. The legislative power delegated to the President of the Republic comes from Art. 62 of the Federal Constitution which states:
"In relevant and urgent cases, the President of the Republic may adopt provisional measures with the force of law and shall submit such measures to Congress immediately. If Congress is in recess, an extraordinary session shall be called within 5 days."

21. Art. 150, clause III of the new Federal Constitution states the following: "without prejudice to any other guarantees ensured to the taxpayer, it is forbidden for the Republic, the States, the Federal District and the Municipalities: III. to collect tributes: a) for taxable events that occurred before the effectiveness of the law that instituted or increased them; b) in the same fiscal year in which the law that instituted or increased them was published;"
and para. 29 of Art. 53 of the previous Constitution declares that:"no tribute will be demanded or increased without the law that so decreed, nor can any tributes be charged or increased, in each fiscal year, if the law that instituted it is no longer effective before the start of the fiscal year, save customs and transport tariffs, tax on industrialized products, and other taxes especially indicated by Supplemental laws, apart from the tax introduced on account of wars and other events as foreseen in this Constitution."

22. Recognizing the defeat of wage control, Provisional Decree No. 68/69 of 10 June 1989 reintroduced global indexation in our taxation system following the model of former Law 7713/88.

[continued from page 402]

policies it considers best suited to the complex interplay of competing interests at any given period. As time passes, sound policies will always translate into increases of the wealth enjoyed by the population of such lucky countries.

Measured by the standard of actual success, one may conclude that some countries in recent years have been able to design and implement a consistent set of intelligent domestic policies, including the tax aspects. Such countries are known as Newly Industrialized Countries (NICs). The tax policies of NICs are very keen not to hinder capital inflows or outflows, either through direct prohibition of expatriation of profits or an induced prohibition of such expatriation by means of heavy progressive taxation. I am using the expression "expatriation" instead of "repatriation" because of present easy global capital investment opportunities.

Based on the recent experience of Brazil and other Latin American economies, where loan capital has increased rapidly over the past 20 to 25 years, while risk capital has increased very slowly, and also considering that in this same period the NICs have had an impressive performance in risk capital investment in their economies, one might wonder whether such different performances may be partly due to different prevailing income tax policies being implemented by such countries.

Considering that the NICs were able to maintain a sustained economic growth over several years, consistently in line with the availability of changing technologies measured by world competition standards, the set of policies underlying the NICs' success appears to be setting a standard for any country to successfully compete for foreign investment. Therefore, it seems realistic to assume that, some time in the near future, Brazilian policy designers may initiate a revision of the existing tax policies affecting foreign investment in Brazil in order to launch a new period of sustained growth in the domestic economy. During such policy re-examination, new rules related to taxation, capital flows and free availability of updated technology will most certainly be the central issues to be discussed.

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BRAZIL:

Developing and Implementing Tax Treaty Policy:

The Tax Sparing Clause

Joseph C. Amico*

I. INTRODUCTION

This article examines how a developing country may formulate and implement its tax treaty policy, particularly using a tax sparing clause. Initially, the relevant concepts of tax treaties are discussed. Then, the developing country's formulation and implementation of its tax treaty policy is examined on 3 levels. First, determination of which concepts of tax treaty policy the developing country wishes to utilize is explored. Second, entering bilateral negotiations with other potential treaty partners is examined. Third, administering a tax treaty network is examined.

II. DEVELOPING A TAX TREATY POLICY

The purpose of tax treaties should be explained before embarking on an analysis of developing tax treaty policies. A tax treaty is generally an agreement between 2 sovereign nations which addresses the issue of how to avoid the double taxation of profits earned in international business and trade. The major purpose of the tax treaty is to override domestic law and generally reduce the level of domestic taxation because the recipient is being taxed twice (once by each of the 2 countries) on the same income. Several specific areas are generally covered in a tax treaty, namely different types of taxation (income, capital, etc.), the taxation of income from different sources (dividends, immovable property, capital gains) and the taxation of income from different activities (personal services, business enterprises, transportation and shipping, etc.). The tax treaty is the result of negotiation between the 2 nations and is ratified by each according to their respective laws.

A developing nation which is formulating a tax treaty policy must first educate itself to the current practices and policies in the international tax sphere. Existing policies reflect the interests of different countries, i.e. industrialized nations have different objectives than developing nations, so the overall policies of similarly situated nations might be analyzed. Domestic tax laws must also be assessed for the important role they play in formulating a tax treaty policy. The treaty practices of nations with similar tax systems may be reviewed to develop insight into alternative means of tailoring the treaty policy to domestic law. The developing nation must then choose which nations it wishes to enter into tax treaties with and for what purposes. A review of the practices of that country will give the developing nation a concept of what positions a potential treaty partner may take in negotiations.

Recent tax treaties generally follow the pattern of the 1977 OECD Model Double Taxation Convention on Income and Capital (in the case of industrialized countries) and the 1980 United Nations Model Double Taxation Convention Between Developed and Developing Countries. The Andean Pact nations have promulgated 2 model conventions for use by members: one for treaties between member states and one for treaties between a member state and a state outside the subregion. The United States of America, as might be expected, has its own Model Convention which it uses as the basis for initiating its tax treaty negotiations.

These documents constitute the starting point of analyzing which current tax treaty policies are suitable to propagating the policies of the developing country. The major policy concerns are usually the taxation of dividends, interest and royalties, methods for the avoidance of double taxation, the taxation of real (immovable) property and capital gains.

III. THE TAX SPARING CLAUSE

A tax sparing clause will generally be of interest to a developing nation which wishes to encourage a particular type of activity by foreign investors within its borders. A tax sparing clause usually provides that regardless of whether a developing country actually taxes the activity, the other party to the treaty will tax such investors resident in it as if the tax had been paid. The following is a rather standard tax sparing clause (Art. 22(4) of the Canada–Singapore tax treaty of 6 March 1976):

> For the purposes of paragraph 2 of this Article, tax payable in Singapore shall be deemed to include Singapore tax which would have been paid if the Singapore tax had not been exempted in accordance with the provisions of Part 6 of the Economic Expansion Incentives (Relief from Income Tax) Act (1970 Edition) of Singapore, so far as they were in force on, and have not been modified since, the date of the signature of this Convention, or have been modified only in minor respects so as not to affect their general character.

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This tax sparing clause gives Canadian taxpayers who receive taxable income from Singapore a credit against Canadian tax for the taxes which would have been paid to Singapore. But as Singapore has adopted domestic legislation which exempts certain activities from income tax, no tax is actually paid to Singapore. Thus, Canadians are encouraged to pursue the activities promoted by Singapore because of the ability to earn income subject to substantially reduced income tax.

Reviewing tax sparing clauses and analyzing what others have done will give the administration of a developing country valuable information about the likelihood of promoting such a policy. For instance, it would learn the United States does not have a treaty in force which contains a tax sparing clause, a reflection of its policy of not endorsing tax sparing clauses. However, the following industrialized nations are willing to sign treaties containing tax sparing provisions:

Australia
Canada
Denmark
Federal Republic of Germany
Finland
France
German Democratic Republic
Ireland
Italy
Korea
Japan
Netherlands
Norway
Luxembourg
New Zealand
Sweden
Switzerland
United Kingdom

The following developing countries have availed themselves of tax sparing provisions with one or more of the above industrialized nations:

Argentina
Bangladesh
Barbados
Belize
Botswana
Brazil
Cameroon
Cyprus
Dominican Republic
Egypt
Falkland Islands
Fiji
Gambia
Ghana
India
Indonesia
Israel
Ivory Coast
Jamaica
Kenya
Kiribati
Liberia
Malaysia
Malta
Morocco
Mauritius
Nigeria
Pakistan
Philippines
Singapore
Sri Lanka
Sudan
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Turkey
Zambia

These research results must be interpreted in connection with certain historic factors. For instance, the United Kingdom has over 20 treaties which contain tax sparing provisions, but almost all of them are with former colonies. However, Canada, the Federal Republic of Germany and Japan have been very liberal in allowing developing countries tax sparing provisions in their tax treaties.

IV. NEGOTIATING A TAX TREATY

A nation embarking on a tax treaty program, as many Eastern European nations have recently, or a nation actively engaged in expanding its treaty network to foster its competitiveness in international commerce, as Malaysia and Indonesia are doing, will wish to assess which nations are potential treaty partners. Historical ties or trade and investment relations are the initial starting point in making this determination. Once the potential partner has been identified, knowledge of that potential partner's current treaty network and the provisions of those treaties will assist the nation in determining whether it would be fruitful to commence negotiations with that partner.

For example, review of the Australia–Korea treaty of 1982 shows that Korea was able to obtain a 5-year tax sparing provision from Australia with respect to certain interest and royalties. Australia, in turn, obtained the concession that its taxpayers who avail themselves of the tax sparing clause would have to gross up their income by the amount of tax forgone.

Review of other Korean treaties reveals interesting patterns. Korea obtained a 10-year tax sparing clause from the United Kingdom in their 1977 treaty. Thus, the United Kingdom and Australia clauses expire at the same time. Korea has also obtained unlimited (as to time) tax sparing clauses from Canada, Denmark, Finland, Japan, Luxembourg and New Zealand. Korea has treaties with the following countries which contain mutual tax sparing provisions: Bangladesh, India, Malaysia, Singapore, Sri Lanka and Turkey. Oddly, the Korea–Philippines treaty gives the Philippines tax sparing, but not Korea. The Koreans are obviously as willing to give as they are to receive.

The Australians, by contrast, are not quite as willing to give a tax sparing clause. Of the 23 Australian treaties examined, only 4 contain tax sparing clauses: Korea, Malaysia, Malta and Singapore. Each of those tax sparing clauses is limited to 5 years effectiveness, unless the parties otherwise agree to extend its application. The generosity of the Australians obviously has limits.

The developing nation can draw obvious conclusions from this simple research. The Koreans will be amenable to inclusion of a tax sparing clause in a treaty to assist the developing nation. By contrast, approaching Australia with the notion the treaty must contain a tax sparing clause of unlimited duration would appear to be an exercise of futility. Thus, the developing nation can narrow the range of prospective partners based upon the historic precedents gleaned from review of the data base.

A corollary of determining which countries are the best prospects for entering into negotiations with, is the negotiating position adopted for the prospective partner. Again, review of the potential partners existing treaties will give valuable information to the developing nation. In addition, analysis of nations in similar circumstances will also provide guidance.

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As an example, take the tax treaties of Brazil. Fourteen of the 16 Brazilian treaties examined have tax sparing provisions. Brazil has tax sparing provisions in its treaties with Austria, Belgium, Canada, Czechoslovakia (not ratified), Denmark, Finland, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, Norway, Spain and Sweden. These tax sparing provisions have varying forms in each treaty.

The Brazil–Germany (Fed. Rep.) treaty contains a tax sparing provision which might exemplify the extent to which particular issues may have to be negotiated. Art. 24, para. 3 of the treaty states:

> For the purpose of the credit referred to in paragraph 2 the Brazilian tax shall be deemed to be:
> (a) in the case of dividends as defined in paragraph 5 of Article 10, 25% of such dividends if they are paid to a resident of the Federal Republic of Germany holding at least 10% of the voting capital of the Brazilian company, and 20% in all other cases,
> (b) in the case of interest as defined in paragraph 4 of Article 11, 20% of such interest,
> (c) in the case of royalties as referred to in paragraph 2(b) of Article 12, 25% of such royalties if they are paid to a resident of the Federal Republic of Germany holding directly or indirectly at least 50% of the voting capital of a Brazilian company, provided that they are not deductible in the determination of the taxable income of the company paying the royalties, and 20% in all other cases.

The credits which a German resident will receive under this provision for Brazilian taxes deemed to have been paid will vary depending upon the type of income it is. Brazilian tax is deemed levied at 20%, as a general rule, for dividends, interest and royalties, with a deemed 25% rate for dividends and interest where the German resident has a substantial shareholding in the Brazilian company. The German position with respect to Brazil was fairly obvious – a 20% tax sparing credit with exceptions for substantial shareholdings.

Contrast this with the other treaties Brazil has concluded which contain tax sparing clauses. The treaties between Brazil and Denmark (25% for royalties and interest), Belgium (20% for dividends, interest and royalties), Canada (25% for dividends, 20% for royalties and interest), France (20% for dividends, interest and royalties), Finland (25% for royalties and interest), Italy (25% for dividends, interest and royalties), Japan (20% for royalties, 25% for dividends and royalties), Norway (25% for dividends, interest and royalties), Spain (20% for interest, 25% for royalties) and Sweden (20% for interest, 25% for dividends and royalties) all contain tax sparing clauses.

The tax sparing clause with Germany is one of Brazil's least beneficial tax sparing provisions. Yet, was Germany less liberal with Brazil than with other nations? A review of Germany's other treaties containing tax sparing provisions reveals the following:

Country	*Tax sparing rates*
Argentina	20% dividends & royalties, 15% interest
Cyprus	15% dividends, 10% interest
China	10% dividends, 15% royalties
Ecuador	20% interest, 20% royalties, 0 dividends
India	½ German tax on dividends, interest & royalties
Indonesia	15% dividends, 10% interest, 10% royalties
Israel	25% dividends, 15% interest
Jamaica	15% dividends, 12.5% interest, 10% royalties
Kenya	15% dividends, 15% interest, 20% royalties
Korea	20% dividends, interest & royalties
Malta	10% interest & royalties
Malaysia	18% dividends, 15% interest, 10% royalties
Mauritius	dividends at local rate
Morocco	15% dividends, 10% interest
Pakistan	20% interest
Philippines	20% dividends & royalties, 15% interest
Portugal	15% dividends, interest & royalties
Singapore	10% interest, 10% royalties
Spain	10% interest (limited)
Sri Lanka	20% dividends & royalties, 15% interest
Trinidad & Tobago	20% dividends, 15% interest, 10% royalties
Tunisia	15% dividends, 10% interest, 10% or 15% for royalties
Turkey	10% dividends, interest & royalties
Uruguay (unrat.)	20% interest & royalties

Two conclusions may be drawn from these results. First the Germans are quite willing to entertain tax sparing provisions in their treaties with developing countries. Second, the Brazilians were able to negotiate very liberal tax sparing provisions with the Germans.

An interesting anomaly of the Germany–Brazil treaty is the higher sparing rate for a substantial shareholding of a German resident in a Brazilian company. This is probably a result of the fact Germany did not implement an indirect foreign tax credit for corporations until 1977. Note the treaty has not been amended to accommodate this change in domestic law.

After a negotiating position has been developed by the developing country, the actual negotiation of the treaty may commence. As the world's tax treaties are now published in a compact disc format, the data base may be transported to the negotiating table and accessed directly on the spot through a portable personal computer. The need to constantly adjourn negotiating sessions so the parties may return to their respective countries and rummage through the library (for materials which are probably out of date) can be reduced because the library is in the negotiating chamber. The question might be answered on the spot by reference to other bilateral or model treaties. In addition, as more international tax information becomes available in the compact disc format the greater the universe of questions which may be answered at the negotiating table as they arise. This does not imply the negotiating will be any easier, just it will be more focused and, hopefully, fruitful for both parties.

The advantages of doing such research are readily apparent. The process of selecting potential treaty partners, developing a negotiating position for that partner and negotiating the treaty requires adequate knowledge of the issues and resources to be conducted effectively.

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V. ADMINISTRATION OF A TREATY NETWORK

Once the treaty has been negotiated and ratified, the developing country must implement the provisions domestically. This process may be facilitated by assessing which provisions are most troublesome and then consulting the regulations of other nations to determine what they have done. Although such regulations are not translated into a common language and published, review of the treaties can start the process by directing the regulation writer to countries which have implemented similar provisions. Through consultation with colleagues in these other nations, the regulation writer may come to a better understanding of the options available without having to go through a trial and error process.

After implementing regulations have been adopted, the developing country must train inspectors to analyze returns with tax treaty issues. Review of the treaty and supporting documentation helps the inspector develop sufficient background in tax treaties to comprehend the issues. A trained inspector looking at a return claiming treaty benefits may also use information about the domestic tax laws of the treaty partner to the advantage of the tax administration. Potentially abusive situations may be identified. For example, a corporation claims treaty benefits because of its residency in the other country. The treaty network of the other country may be examined to see if there exists a loophole in the tax net which allows the shareholders to avoid taxation altogether, a situation which the treaty was not intended to benefit.

VI. CONCLUSION

The formulation of a tax treaty policy by a developing country may best be accomplished by first referring to the world's existing treaties and several important models to see what patterns, topics and issues are of greatest concern. It must decide which domestic policies it wishes to promote and determine how it may accomplish those goals through tax treaties. The use of a tax sparing clause should be given consideration, in connection with domestic legislation, to promote foreign investment and economic development. Potential treaty partners may then be pinpointed based on their previous practices. Negotiations with potential partners may be facilitated by focusing on the more important issues and determining what positions the potential treaty partner is likely to take. Finally, administration of the treaty network may be fomented by reference to the practices of other nations' administration systems.

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Botswana

TAX INFORMATION SUMMARY.
Incorporating 1988/89 Tax Amendments and 1988/90 Budget proposals together with an outline of Exchange Control Regulations.
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(B. 13.383)

Zimbabwe

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Harare, The Commissioner of Taxes and The Director of Customs and Excise, Private Bag 7715, Causeway, Harare, 1989, pp. 20.
This booklet sets out the Government policy on local and foreign investment in Zimbabwe.
It covers exchange control and taxation.
(B. 13.393)

ASIA & THE PACIFIC

Papua New Guinea

TAX FACTS AND FIGURES 1989.
Port Moresby, Coopers & Lybrand, P.O. Box 484, 7th Fl., Mogoru Moto Bldg., Champion Parade, Port Moresby, 1989, pp. 32.
Information on significant features on income tax and other taxes in Papua New Guinea for the fiscal year ending 31 December 1989 based on the law as at 31 December 1988.
(B. 57.298)

EUROPE

EUROPEAN AFFAIRS. SPECIAL ISSUE on the European symposium. Including the Second World ECU symposium.
Amsterdam, Elsevier, 1989, pp. 329.
This special issue of "European Affairs" contains extracts of most of the lectures given at the "European Finance Symposium", including the "Second World ECU Symposium" from 2-6 November 1988 in Antwerp. The subjects discussed were on taxation, financial management, insurance and monetary integration. Topics on taxation include: "The Single Act and indirect taxation" by Giuseppe Guarino; "Harmonization of enterprise taxation in the European Community" by Robert Goergen; "European trends in direct taxation towards 1992" by Michael Maskall.
(B. 109.165)

Austria

TWAROCK, Alfred; WITTMANN, Rudolf; FRÜHWALD, Karl.
Kommentar zum Bewertungsgesetz.
Vienna, Verlag Anton Orac.
Supplemented: annually.
Second edition of a loose-leaf guide containing the text and amendments to the Valuation Law of 1955 and the commentaries thereto. Included in the commentary are the most recent developments in the higher and lower courts after the Amendment Law of 1972 which has brought legal insecurity by abolishing some valuation prescriptions introduced in the Amendment Law of 1971.

POLLAK-BÜRGEL, P.; ARMING, W.
Programmierte Steuerübersicht in Tabellenform Systematisch gegliedert.
Vienna, Verlag Anton Orac.
Supplemented: as needed.
A survey containing a tabulated overview of many aspects of Austrian tax law, e.g. procedural law, income taxes, transfer taxes, net worth taxes, stamp duties, etc.

STEUERRECHTLICHE Tabellensammlung.
Vienna, Verlag Anton Orac.
Supplemented: two or three times a year.
Loose-leaf publication containing 450 tables relating to turnover taxes, social securities, etc. Information of tax rates in previous years has been included.

PHILIPP, A.
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Vienna, Verlag Anton Orac.
Supplemented: regularly.
Loose-leaf publication containing the text of the Trade tax Act 1953, as amended, and implementing laws and rulings thereto.

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Die Einkommensteuer 1972.
Vienna, Verlag Anton Orac.
Supplemented: regularly twice per year.
Loose-leaf publication in three volumes dealing exclusively with income tax in Austria. Volume I contains in two binders the full consolidated text of the present income tax law. Volume II contains in three binders the condensed texts of relevant case law as of May 1976. Volume III contains a detailed commentary on the income tax.

BREINL, G.
Das Handbuch der Vereine. Der Verein in steuerlicher, wirtschaftlich organisatorischer und rechtlicher Sicht.
Vienna, Verlag Anton Orac.
Supplemented: irregularly.
Loose-leaf publication dealing with the tax, economic and legal aspects of clubs and other similar associations of persons.

KRANICH, Alexander; SIEGL, Hanskarl; Waba, Josef.
Kommentar zur Mehrwertsteuer.
Vienna, Verlag Anton Orac.
Supplemented: regularly (at least annually).
Loos-leaf publication containing text of and commentaries on the value added tax in Austria. Worked examples, references to case law elucidate the problems.

CZURDA, Alois.
Kommentar zum Grunderwerbsteuergesetz.
Vienna, Verlag Anton Orac.
Supplemented: regularly.
Loose-leaf publication on the Austrian transfer tax on real property. Full text of the law and implementing statutes are printed. Case Law, worked examples illustrate the explanation of Civil Law in connection with the subject is considered. Great attention is paid to the tax incentives for construction activities. A comprehensive is appended.

FELLNER, K.W.
Gebühren und Verkehrsteuern, Stempel- und Rechtsgebühren, Grunderwerbsteuer, Erbschafts- und Schenkungssteuergesetze, Kommentar mit Entscheidungen, Bewertung, Bilanz- und Berechnungsbeispiele.

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Available from the author Mr. K.W. Fellner, Resselstrasse 8, 4470 Enns.
Supplemented: as needed.
Loose-leaf publication in three binders containing the text of and a commentary on general principles and procedures of the following taxes: fees, transfer tax, stamp duties levied on various kinds of legal or official documents and the inheritance and gift tax, including valuation aspects and computation examples.

LAGER, Anton.
Das Recht der Doppelbesteuerung in Österreich.
Vienna, Verlag Anton Orac.
Supplemented: once per year.
Loose-leaf publication in two binders on Austrian international tax law, containing general explanations of terms used in international tax law such as domicile, permanent establishment, etc., texts of and comments on double taxation treaties concluded by Austria, case law and regulations. Full text and explanation of the OECD Model treaties on direct taxes and on death duties are appended.

Belgium

De THEUX de MEYLANDT et MONTJARDIN, Jacques; BADOT, Alfred.
Le leasing mobilier en Belgique. Aspects pratiques, comptables et fiscaux.
Brussels, Etablissements Emile Bruylant S.A., 1989, pp. 137.
Monograph describing the legal aspects and finance methods of leasing movables in Belgium in the last 5 years.
(B. 109.026)

EEC

MATTAUSCH, Hubert.
Betriebsstättenprinzip und EG-Binnenmarkt – ein Gegensatz?
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Hefte zur Internationalen Besteuerung, No. 49, pp. 35.
Seminar dealing with the importance of the permanent establishment principle to the E.C. tax harmonization with respect to the European Internal Market.
(B. 109.032)

JUDGMENT OF THE COURT, 23 November 1988.
Common system of value added tax – Taxable amount – Supplies of goods and services.
Luxembourg, Court of Justice of the European Communities, 1988. Case J 230/87, pp. 11.
(B. 109.152)

GLEED, Richard; BAKER, Andrew; BLACKNELL, Andrew.
Deloitte's 1992 guide.
London, Butterworths Law Publishers Ltd., 1989, pp. 126. £ 15.
This book on 1992 has been prepared in close collaboration with the European Communities Office in Brussels in order to give a succinct overview of the major parts of the European Community's 1992 Programme.
(B. 109.051)

IMPORT – EXPORT. GUNSTREGELINGEN en procedures in de B.T.W.- en Douanereglementering.
Co-authors: J. Brassine, J. Koedijk, J. Marckx, etc.
Antwerp, Kluwer Rechtswetenschappen, 1988. 1.950.- Bfrs.
Loose-leaf publication with respect to import and export of goods as it affects value added tax and customs duties. European Community Directives in the light of the creation of an European Single Market.
(B. 108.995)

BOS, P.V.F.; FIERSTRA, M.A.
Europees mededingingsrecht.
Deventer, Kluwer/The Hague, Fenedex, 1989.
Fiscale en juridische documentatie voor internationaal zakendoen, No. 21, pp. 274.
Monograph describing the various aspects of competition law within the European Single Market.
(B. 108.969)

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Guide containing concise information on rights and responsibilities of aliens resident in Finland, especially in respect of immigration, social security and taxation matters.
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France

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Handbuch der Bauinvestitionen und Immobilien-kapitalanlagen. Heidelberg, C.F. Müller Juristischer Verlag, Kriminalistik, Postfach 102640, 6900 Heidelberg.
Loose-leaf, supplemented: four or more times per year. Price Basic Volume 348.– DM. Latest supplement No. 34, 94.40 DM.
Detailed commentary in six binders on the various tax aspect of models to become an owner of immovable property in Germany or to participate in a fund investing mainly in immovable property. Included are commentaries to court decisions concerning tax and civil law aspects. In the 34th supplement are court decisions concerning business tax, income tax, value added tax, and civil law dealt with.

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Supplemented: four or more times per year.
Loose-leaf publication in four volumes providing an extensive commentary on the German Income Tax Law (on individuals), illuminated by numerous practice-oriented examples concerning the impact of the imputation system. The texts of the Income Tax Law as well as of related laws and ordinances are appended. Since the Tax Reform Law of 25 June 1988, the Income Tax Law has been amended six times. The latest five supplements deal with those changes and commentaries thereto.

DIE VERANLAGUNG 1989 LOHNSTEUER.
Einkommensteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. 5. Auflage.
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(B. 108.980)

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Umsatzsteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. 31. Auflage.
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Frankfurt am Main, Peter Lang Verlag. 1989.
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KRAEMER, Joachim.
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Bonn, Stollfuss Verlag, 1987, pp. 196. 79.- DM.
Legal protection concerning execution in tax law. The author discovered a lack of information by both the tax authorities and most of the taxpayers and with this book demonstrates the procedures according to the provisions of the Fiscal Code and the Code of Civil Procedure.
(B. 108.958)

MEYER, Harald.
Beweislastprobleme im Steuerrecht.
Augsburg, Karten Kock Verlag, Am Hinteren Perlachberg 1 c, 8900 Augsburg, 1988, pp. 128.
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Bilanzanalyse und Bilanzpolitik. Vorträge und Diskussionen zum neuen Recht.
Düsseldorf, IDW Verlag, 1989, pp. 394. 44.86 DM.
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Frankfurt am Main, Peter Lang Verlag, 1988.
Finanzwissenschaftliche Schriften, Band 37, pp. 330.
Processes in development of an informed opinion in the EEC relating to tax policy. Harmonization of value added tax. Note: "Harmonizing La Bohème with Götterdämmerung would be easier than harmonizing EEC taxes".
(B. 108.928)

GRUNDSÄTZE ORDNUNGSMÄSSIGER
Buchführung bei computergestützten Verfahren und deren Prüfung; Generally accepted accounting principles in computer-assisted accounting systems and the audit of such systems.
Düsseldorf, IDW Verlag, 1989, pp. 96. 28.- DM.
Text in German and English language of opinion presented by the Committee on Modern Accounting Systems supersedes Opinions FAMA 1/1972, 1/1974 and 1/1975 and Pronouncement FAMA 1/1978.
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Herausgegeben von Kurt Schmidt.
Berlin, Duncker & Humblot GmbH., 1988.
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(B. 108. 858)

Netherlands

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(B. 109.141)

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(B. 109.181)

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Oslo, Dyade Fagboker; Ole Gjems-Onstad, Olav Aukrusts vei 56 B, N-0390, Oslo 3, 1989, pp. 410.
Compilation of articles discussing taxation of charitable organizations.
(B. 109.146)

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United Kingdom

BRITISH TAX ENCYCLOPEDIA.
Editors: G.S.A. Wheatcroft and Philip Lawton.
London, Sweet & Maxwell Ltd., 4, Bloomsbury Square, London WC1A 2RL.
Supplemented: four or more times per year.
Loose-leaf publication in six volumes comprising annotated text of the income tax, corporation tax and capital gains tax laws. The commentaries and explanations thereto are published in separate bound textbooks entitled Whiteman & Wheatcroft on Income Tax; Wheatcraft and Whiteman on Capital Gains Tax, and Richard Bramwell Taxation of Companies, which are supplied automatically to subscribers to the British Tax Encyclopedia, but which are also sold as separate publications.

SIMON'S TAXES.
Editorial Board: Sir John Foster, K.S. Carmichael and B.J. Sims.
Editors for Scottish Law: W.F. Bowes and D.W. Bond.
London, Butterworth & Co.
Supplemented: at least six times per year.
Loose-leaf publication in nine volumes covering income tax, corporation tax and capital gains tax. Volumes A, B and C deal with administration, procedure and computation of these taxes. Volume D deals with the taxation of companies and Volume E with the taxation of individuals and trusts. Volume F is devoted to double taxation relief. Volumes G and H contain Acts, statutory instruments and extra-statutory concessions. Each of these volumes has its own index, while Volume I comprises a comprehensive index to the whole work, together with Tables of cases and Statutes.

SIMON'S WEEKLY TAX SERVICE.
London, Butterworth & Co.
Supplemented: weekly.
Loose-leaf publication entitled Simon's Weekly Tax Service comprising Simon's Tax Intelligence and Simon's Tax Cases each with its own binders. (1) Simon's Tax Intelligence, records recent developments on tax matters, provides detailed summaries of all tax cases decided during the week, all relevant statutory instruments reproduced in full, all press releases issued by the Inland Revenue and by the Customs and Excise regarding value added tax and announcements as to the publication of Command Papers and explanatory booklets, Finance Bill Amendments, etc. (2) Simon's Tax Cases, records United Kingdom tax cases, covering income tax, corporation tax, capital gains tax, capital transfer tax, stamp duty and value added tax.

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The law referred to in this book is the position at 30 June 1988.
(B. 109.087)

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Croydon, Tolley Publishing Company Ltd., 1988, pp. 417. £ 15.95.
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(B. 109.086)

GRANDE-BRETAGNE. GUIDE juridique, fiscal, social et comptable. 2nd Edition.
Paris, Editions Francis Lefebvre, 1988.
Dossiers internationaux Francis Lefebvre, pp. 433. 345.- Ffrs.
Second edition of work describing the common law and company law, social and accounting regulation in England. The tax system and the comprehensive income tax treaty between France and the United Kingdom is also dealt with.
(B. 109.047)

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Croydon, Tolley Publishing Company Ltd., 1989, pp. 1120.
This book deals with subjects such as: buying a company, capital gains tax basic planning, company migration, computers and tax planning, employee benefits, foreign tax planning and various other subjects. Included are descriptions of tax planning in Gibraltar, Jersey, Guernsey and the Isle of Man.
(B. 109.085)

EASTAWAY, Nigel; EDWARDS, John; O'HANLON, Emelda.
Tolley's taxation of Lloyd's underwriters. 2nd Edition.
Croydon, Tolley Publishing Company Ltd., 1988, pp. 266. £ 29.95.
Monograph describing the taxation of Lloyd's underwriters. The law is stated as at 1 August 1988.
(B. 109.088)

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(B. 109.072)

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£ 150.-.
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(B. 109.058)

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Croydon, Tolley Publishing Company Ltd., 1988, pp. 600. £ 12.25.
Compilation of taxation questions with annotated solutions taken from examination papers of professional accountancy bodies, the Institute of Taxation and the Law Society, all reviewed in the light of the legislation current for 1988/89 including Finance Act 1988. The examples (questions and solutions) are preceded by a summary of the relevant provisions of the inheritance tax, value added tax.
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TOLLEY'S VAT PLANNING 1989.
A practical guide to value added tax planning, including the legislation and relevant case law to 1 October 1988. Edited by Patrick Noakes.
Croydon, Tolley Publishing Co Ltd., 1989, pp. 420. £ 18.95.
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DE VOIL, Paul W.
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Supplemented: monthly.
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London, Sweet & Maxwell, 1988, pp. 815.
£ 110.-.
Third revised edition of monograph describing the inheritance tax effective as of 1 August 1988. The work has been pruned and the chapter on planning, the material on interaction of inheritance tax with other taxes as well as texts of double tax treaties have been left out with the aim not becoming too big and, therefore, inaccessible to a number of readers.
(B. 109.057)

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Tolley's estate planning. A practical guide to estate planning, including the legislation and relevant case law to 1 November 1988.
Croydon, Tolley Publishing Company Ltd., 1988, pp. 386.
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QUALITY OF JUSTICE.
The Bar's response.
General Council of the Bar.
London, Butterworth & Co., 1989, pp. 275.
The General Council of the Bar of England and Wales publishes this book in response to the Government's three Green Papers of 1989 on some aspects of the system of justice in England and Wales.
(B. 109.168)

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INTERNATIONAL

INTERNATIONAL TAX SUMMARIES 1989.
A guide for planning and decisions. Edited by Edwin J. Reavey.
Amsterdam, Coopers & Lybrand Belastingadviseurs, P.O.Box 53009, 1007 RA Amsterdam, 1989, pp. 1200.
Annual edition of an overview of the tax systems in 97 countries with emphasis on both individual and corporate income taxes prepared by members associated with Coopers & Lybrand (International). The tax systems reflect the situation as of 31 July 1988 unless otherwise indicated.
(B. 109.135)

TAXING CONSUMPTION.
Paris, Organisation for Economic Co-operation and Development, 1988, pp. 333. 170.- Ffrs.
Report prepared by the OECD Secretariat with the assistance of S. Cnossen of Erasmus University – Rotterdam, C. Sandford of the University of Bath and R. Bird of Toronto University modified by discussions of Working Part No. 2 on Tax Analysis and Tax Statistics of the Committee on Fiscal Affairs. This report provides a comprehensive survey of OECD country practices on value added tax over the last two decades as well as an analysis of the policy and practical choices that governments have had to make in taxing goods and services.
(B. 108.854)

THE INTERNATIONAL TAX TREATIES Service.
Edited by Mr. Edwardes-Ker.
Dublin, In-Depth Publishing Ltd., Alton House, Herbert Street, Dublin 2, Ireland, 1977.
Loose-leaf publication, 2 volumes, updated irregularly, latest update No. 10, February 1989.
Price update No. 10: US$ 265.
Publication service which analyzes the OECD 1977 Model Tax Convention on an article by article basis. In relation to each article, the text of the article is quoted followed by the Commentary, and then by Editorial comments. Then each court decision or ruling in any State relating to that particular article is analyzed. The latest update analyzes 251 new decisions and rulings. This service now covers 1716 decisions and rulings.

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DeLisle Worrell:

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DeLisle Worrell:

Das Steuersystem in Barbados *457*
Die 4 wichtigsten Einnahmequellen von Barbados sind die Steuern auf inländische Waren und Dienstleistungen, die Steuern auf importierte Waren, die Steuern auf Einkommen und die Sozialversicherungen. Es gibt besondere Regelungen für die Steuerbefreiung von Investitionen, neuen Unternehmen, Exportwaren und Off-shore Gesellschaften. Herr Worrell beschreibt diese Merkmale des Steuersystems in Barbados ebenso wie das Netz von Doppelbesteuerungsabkommen und den Einfluss der Steuern auf das Wirtschaftssystem von Barbados.

Bruce Zagaris:

Barbados: Entwicklungen im offshore finanziellen Sektor *463*
Die Erläuterungen zum Haushalt, die im April 1989 veröffentlicht wurden, zeigen, dass Barbados als Zentrum internationaler geschäftlicher Dienstverleihung eine bedeutende Zunahme erlebt hat. Die Regierung hat sich zum Ziel gesetzt, Massregeln zur Förderung dieser Entwicklung zu nehmen.

Pedro Massone:

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Mexiko hat kürzlich eine jährliche Vermögensteuer von Unternehmen eingeführt, welche ab dem Steuerjahr 1989 verschuldet ist. Die Vermögensteuer muss mit den Steuern vom Einkommen zusammen bezahlt werden, darf jedoch von diesen Steuern abgezogen werden. Dieser Artikel beschreibt die wichtigsten Merkmale der neuen Vermögensteuer.

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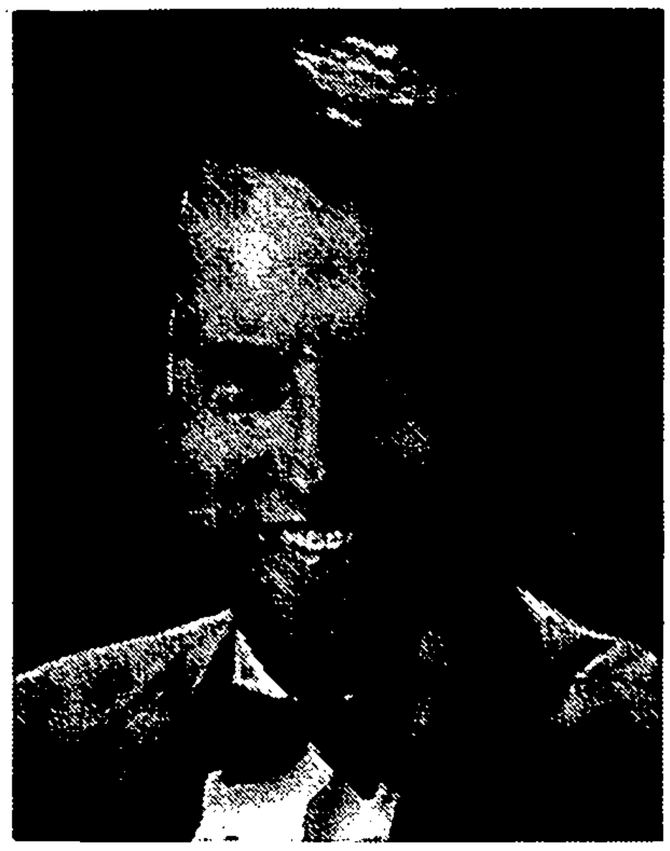
UNITED STATES:

Limitations on the Foreign Tax Credit

Thomas H. Gibson



Thomas Gibson is Partner, International Tax Services Special Practice Unit, Price Waterhouse, Palo Alto, California. Outline prepared with the Assistance of Kevin E. Dillon, Senior Manager, International Tax Services Special Practice Unit, Price Waterhouse, Palo Alto, California.

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K. Addition of Sec. 904(f)(5)(F)
L. Amendment of Sec. 904(g)(10)(11)
M. Addition of Sec. 964(d)

XIV. 19 JANUARY 1989 TEMPORARY REGULATIONS REGARDING FOGEI AND FORI

I. GENERAL BACKGROUND

The foreign tax credit (FTC) limitation was introduced in the Revenue Act of 1921 to avoid foreign tax credits generated by foreign tax on foreign source income being utilized against U.S. tax on U.S. source income. The limitation was originally imposed as an overall limitation (foreign taxes paid to different foreign jurisdictions lumped together), was changed to a per country limitation to prevent the averaging of high and low foreign tax rates (cross crediting) and reverted to the present overall limitation in 1976. The foreign tax credit mechanism aims at preventing the double taxation of foreign source income which is to be taxed up to the higher rate of the respective foreign country or the United States. The Tax Reform Act 1986 (TRA 86) significantly impaired cross crediting by expanding the number of separate limitation baskets, amending the sourcing rules and tightening the Regulation (Reg.) Sec. 1.816-8 expense allocation and apportionment rules. The revenue estimate and regulatory priority given to foreign tax credit limitation issues indicate the importance to multinationals of foreign tax credit limitation planning to minimize global taxes after 1986.

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II. FOREIGN TAX CREDIT LIMITATION FORMULA

Sec. 904(a) contains the limitation calculation formula. The formula effectively applies the U.S. tax rate to foreign source taxable income for a taxable year as follows:

$$\frac{\text{Taxable income from sources without the U.S.}}{\text{Total taxable income}} \times \text{U.S. tax before credits}$$

III. FOREIGN SOURCE TAXABLE INCOME

Foreign source taxable income may be increased (TRA 86 is likely to produce excess FTC) by increasing foreign source gross income and by reducing the expenses allocated and apportioned to that foreign source gross income.

A. Foreign source gross income

The sourcing rules are contained in Internal Revenue Code (IRC) Secs. 861-863 together with Sec. 865 and accompanying Regulations. TRA 86 brought about significant changes in the sourcing rules by introducing the residence of seller criteria for the sale of certain non-inventory property. The title passage criterion was retained for inventory property. The 50-50 apportionment formula in Reg. Sec. 1.863-3 was retained and has been clarified by Announcements 89-10 and 89-11. The source rules before and after TRA 86 are as follows:

Nature of income	Source rule	
	Pre TRA 86	Post TRA 86
Sale of purchased inventory property	Title passage	Title passage
Sale of manufactured inventory property	Title passage Sec. 863(b) allocation 50% to sales 50% to manufacture	Title passage Sec. 863(b) allocation 50% to sales 50% to manufacture
Non contingent sale of intangible property	Title passage	Residence of seller (foreign office participation exception)
Royalties from, contingent sales of intangible property	Place of use	Place of use
Sale of personal property (tangible, non-inventory used in trade or business):		
Recapture income	Title passage	Where deductions offset income (foreign office participation exception)
Gain	Title passage	Title passage
Sale of other personal property (tangible, non-inventory) including passive investment property	Title passage	Residence of seller
Interest		
Generally	Residence of payor	Residence of payor
U.S. 80/20 company	Foreign source if less than 20% GI U.S. source over 3-year period	If meets 80% active foreign business requirement wholly foreign to unrelated U.S. and foreign recipients. Pro rata foreign to related U.S. and foreign recipients (look through rule for 10% U.S. shareholders if more than 50% U.S. controlled).
Dividends		
Generally	Residence of payor	Residence of payor
U.S. 80/20 company	Foreign source if less than 20% GI U.S. source over 3-year period	U.S. source

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B. Allocation and apportionment of expenses

Reg. Sec. 1.861-8 details the methodology to apply in specifically allocating certain expenses and apportioning remaining expenses among the defined statutory groupings of gross income and a residual grouping of gross income. Expenses which are subjected to specific rules of allocation and apportionment to the statutory and residual groupings of gross income include, among others, interest and research and development (R&D) expenses. TRA 86 has effected the following major changes:

1. All expenses are to be allocated and apportioned on the basis of the U.S. affiliated group (including Sec. 936 corporations) under the provisions of Sec. 864(e)(1) and (5)[1].

2. Interest is to be allocated on a consolidated group basis by utilizing a modified asset method. The optional gross income method is eliminated.[2]

3. The moratorium on the allocation of research and development (R&D) expense to U.S. income was extended for a year. For taxable years beginning on or after 1 August 1986 and on or before 1 August 1987, R&D may be allocated on a separate company basis with an automatic 50% allocation to U.S. source income, the balance being allocated under either a sales or gross income method. Allocation to foreign source income under the gross income method need not equal at least 50% of such allocation under the sales method. This transitional provision represented significant tax benefit to appropriately structured companies.

4. See Sec. XIII for 1988 Act provisions.

C. Sec. 904(g) resourcing rules

The following items of income derived from U.S. owned foreign corporations may be wholly or partly sourced as U.S. source income:

1. Subpart F income (Sec. 951(a)) and foreign personal holding company income (Sec. 551) or inclusions from passive foreign investment companies that have made QEF elections (Sec. 1293) might be resourced to the United States to the extent attributable to U.S. source income of U.S. owned foreign corporation;

2. Interest might be resourced to the United States to the extent properly allocable to income of the U.S. owned foreign corporation from U.S. sources;

3. Dividends might be resourced United States to the extent of the "U.S. source ratio" (ratio of U.S. source earnings & profits (E&P) to total E&P) of U.S. owned foreign corporation;

4. Dividends from Sec. 936 corporations, Sec. 1248 dividends and Sec. 1246 gains treated as in "3" above.

A 10% de minimis rule applies with respect to interest and dividends which are not resourced if less than 10% of current year E&P is attributable to U.S. sources. "U.S. owned foreign corporations" are owned 50% or more in voting power or value by U.S. persons.

IV. SEC. 904(a) FORMULA AND OVERALL LIMITATION

A. General application

The overall limitation constitutes the residual "basket" (Sec. 904(d)(1)(I)) for all items of income other than those to which the Sec. 904(a) limitation calculation is separately applied. The foreign tax credit in respect of non-separately limited foreign source income cannot effectively exceed the product of the foreign source taxable income in this category and the effective pre-credit U.S. tax rate. Excess credit or limitation will result when the average foreign rate of tax on income in this category does not equal the U.S. pre-credit effective rate (determined after the allocation and apportionment of parent-level expenses).

Foreign source income is determined with reference to U.S. tax principles. U.S. tax exempt income is excluded from both numerator (foreign source taxable income) and denominator (total taxable income) even though subject to a foreign tax. Expenses are allocated to the foreign source gross income in the overall basket under Reg. Sec. 1.861-8. Foreign taxes not specifically allocable to foreign source income separate limitation baskets (statutory groupings) under Reg. Sec. 1.861-8(e)(6) may be allocated under certain other prescribed formulae (Reg. Sec. 1.904-4(d)(2)(ii) with respect to non business interest and Reg. Sec. 1.904-5(b)(2)(ii) with respect to DISC dividends).

B. Foreign source taxable income and capital gains

Prior to the elimination of the capital gain rate differential, adjustments were necessary with respect to foreign source capital gains of corporations:

1. The capital gain included in the numerator was limited to "foreign source capital gain net income," that is, the lesser of capital gain net income (total capital gains in excess of total capital losses). This netting adjustment[3] prevented foreign source capital gains being included in the numerator though not taxed in the United States being offset by U.S. capital losses. The denominator is similarly adjusted in that capital gains are included only to the extent of "capital gain net income".[4]

2. The numerator was reduced by the "rate differential portion" of "foreign source net capital gain" while the denominator was reduced by the "rate differential portion" of "net capital gain".[5] The "rate differential portion" constituted the following fraction:

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1. Senate Comm. Rep. at 605 indicated that this was not intended to apply to Sec. 936(h). Proposed Regulation 1.861-9(b)(2) confirms that group basis interest allocation does not apply for computing CTI under the profit split method.
2. Sec. 864(e). See also Proposed Regulations 1.861-8 through 1.861-10.
3. Sec. 904(b)(3)(A).
4. Sec. 904(b)(3)(A)(ii).
5. Sec. 904(b)(2)(A)(ii).

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$$\frac{\text{Sec. 11(b) highest rate of tax} - \text{Sec. 1201(a) alternative rate}}{\text{Sec. 11(b) highest rate}}$$

The rate differential adjustment aimed at preventing foreign source long-term capital gains taxed at the lower U.S. rate nonetheless being included in the numerator of the limitation calculation and, conversely, U.S. source long-term capital gains being included in the denominator. The rate differential portion before TRA 86 was $^{18}/_{46}$ $\frac{(46-28)}{46}$.

TRA 86 reduced the Sec. 11(b) rate to 35% for tax years beginning on or after 1 July 1987 and increased the Sec. 1201(a) rate to 34% for tax years beginning after 31 December 1986. A Sec. 1201(a) transitional rule, however, applied to tax years beginning before 1 January 1987 and ending after that date and provided that corporations with net capital gains derived in such a year where the Sec. 11(b) and Sec. 1201(a) blended rate of tax exceeded 34% could utilize 34% as the alternative tax rate on the capital gains.

3. Foreign source net capital loss, to the extent taken into account in determining capital gain net income (total capital gains in excess of total capital losses) to be included in foreign source taxable income was reduced by the following amount:

Rate differential portion × (U.S. source net capital gain – Net capital gains)

The numerator of the limitation fraction is thereby increased.

The purpose of this adjustment was to prevent the taxpayer's limitation calculation being detrimentally affected by foreign source ordinary income being wholly or partly offset by foreign source net capital losses. Existing case law requires high taxed foreign source ordinary income to be offset by foreign source capital losses in the numerator of the limitation fraction (to the extent the foreign source capital loss offsets U.S. source capital gain in the denominator) but not in the denominator. The adjustment[6] only applies to foreign source net capital losses that reduce U.S. source net capital gains (long term) in the denominator.

4. Prior to TRA 86, IRC Sec. 904(b)(3)(C) resourced the gain from the sale of certain personal property to the United States unless the gain was subjected to foreign taxes at a rate of 10% or more. The resourced gain was treated as U.S. source income for purposes of Sec. 904(b) only. The purpose of the resourcing rule was to prevent taxpayers from increasing the numerator of their limitation fraction by utilizing the title passage rule applicable to the sale of personal property to their benefit. TRA 86 changed the sourcing rules for the sale of personal property for all purposes (in general, sourced to the residence of the seller for tangible, non-inventory, non-trade or business property) and accordingly deleted the above resourcing rule for Sec. 904(b) purposes.

5. Both the numerator and the denominator of the foreign tax credit limitation fraction applicable to Sec. 936 corporations exclude taxable income taken into account for purposes of Sec. 936 possession credit.[7]

V. SEPARATE LIMITATION RULES: SEC. 904(d)

Sec. 904(d) requires certain items of income to be grouped separately into individual "baskets" comprising separate statutory groupings and a residual grouping (the overall basket referred to in IV.A. above). The limitation fraction rules relating to the computation of taxable income and the carryover and carryback of foreign tax credits apply separately to each basket. The objective of the separate limitation rules is, in general, to prevent, for example, low taxed foreign source taxable income from being sheltered from U.S. taxation by the "cross crediting" of foreign taxes from high taxed foreign source taxable income. TRA 86 has severely restricted ongoing cross crediting opportunities.

A. Separate limitation rules before TRA 86

Pre-TRA 86 separate limitation baskets under Sec. 904(d) comprised the following:

1. Non-business, non-related party interest

Interest, imputed interest and amounts treated as interest under Sec. 904(d)(3) were, in general, subjected to a separate limitation calculation to prevent excess credits from being absorbed by low taxed foreign source interest income. The following exceptions applied:

(a) Interest on transactions related to the active conduct of trade or business in the source foreign country;
(b) Foreign source interest income from a banking, financing or similar business (services provided to the public);
(c) Interest received from a corporation 10% or more of the voting stock of which is owned directly or indirectly by the taxpayer or by an includible corporation in the affiliated group with which the taxpayer files a consolidated return. However, interest paid or accrued by a foreign corporation 50% or more of the voting power or value of which is owned by U.S. persons (a "designated payor corporation"), for example, may be treated as separate limitation interest up to the net separate limitation interest of the designated payor corporation. Interest received or accrued by the designated payor corporation from another member of the same affiliated group (foreign corporation included for these purposes) is not treated as separate limitation interest except by look through to the other member.[8] A 10% de minimis rule applied to the separate limitation interest included in the earnings and profits of the designated payor corporation.
(d) Interest received on obligations arising out of the disposition of an actively conducted foreign trade or business or out of the disposition of stock or obligations of a corporation 10% or more of the voting stock of which was owned by the taxpayer.

6. Sec. 904(b)(2)(B)(iii).
7. Sec. 904(b)(4).
8. Sec. 904(d)(3)(J).

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Dividends paid or accrued by a designated payor corporation were, in certain circumstances, treated as separate limitation interest income under the designated payor rules and exceptions.

2. Domestic International Sales Corporations (DISC) dividends

Dividends from an interest charge DISC or from a former DISC, to the extent treated as foreign source income, were subjected to a separately applied foreign tax credit limitation fraction. Any deemed foreign paid tax credit associated with the DISC dividends was accordingly separately limited. The low taxed or untaxed foreign source taxable income from DISC dividends could accordingly not be utilized to absorb excess credits from other foreign source taxable income.

3. Taxable income attributable to foreign trade income of a Foreign Sales Corporation (FSC)

In order to prevent FSCs with high taxed foreign source non-foreign trade income from being able to utilize untaxed (or low taxed) foreign source exempt foreign trade income to increase the numerator in an overall foreign tax credit limitation fraction, the taxable income attributable to foreign trade income of an FSC was subjected to a separate limitation calculation. The exempt foreign trade income portion will be foreign source income[9] while the non-exempt portion is likely to be U.S. source income.[10]

4. FSC dividends

Dividend distributions from an FSC or former FSC out of earnings and profits attributable to foreign trade income are required to be subjected to a separate limitation calculation by the recipient shareholder. FSC dividends will generally constitute foreign source taxable income subjected to little or no foreign tax. Inclusion in the recipient shareholders overall limitation basket would permit the utilization of otherwise excess foreign tax credits generated by other high taxed foreign source taxable income. In effect, the only deemed paid foreign tax credit available to the recipient shareholder with respect to the foreign trade income of the FSC is the withholding tax imposed on the distribution of non-exempt foreign trade income not determined by application of administrative pricing rules.[11]

5. Foreign oil and gas extraction income

Sec. 907 provides a separate limitation amount for the crediting of foreign taxes on foreign oil and gas extraction income. Taxes in excess of the limitation amount are reduced to the highest rate of U.S. corporate tax applied to the amount of foreign oil and gas extraction income for purposes of the overall foreign tax credit limitation calculation.

6. Allocation rules for foreign taxes

Regs. 1.904-4(d)(2)(ii)-5(b)(2)(ii) prescribe formulas for allocating foreign taxes that cannot otherwise be specifically allocated to the taxpayer's separate limitation income.

B. Separate limitation rules after TRA 86

TRA 86 created new separate baskets for the following categories of income (other categories of income fall within the residual or overall basket):

1. Passive income (an expansion or prior law separate basket for interest now includes foreign personal holding company (FPHC) type income under Sec. 954(c) together with inclusions in gross income under Secs. 551 and 1293);[12]
2. High withholding tax interest (5% or higher withholding tax rate imposed by a foreign country or possession);[13]
3. Financial services income (if derived in the active conduct of a banking, financing or similar business and certain income of insurance companies);[14]
4. Shipping income (foreign base company shipping income as defined in Sec. 954(f));[15]
5. Dividends from each "non-controlled Sec. 902 corporation.[16]

and *retains* the following separate baskets:

6. Taxable income attributable to foreign trade income of FSCs;
7. Interest charge DISC (or former DISC) dividends to the extent treated as foreign source income;
8. Distributions from FSC (or former FSCs) out of earnings and profits attributable to foreign trade income;[17]
9. Foreign oil and gas extraction income limitation amount.

The new baskets are subject to the following definitions, exceptions and special rules (numbered as above) applicable to foreign source income earned directly by a U.S. taxpayer:

1. Passive income basket

Passive income comprises (1) income received or accrued "which would be" Subpart F Sec. 954(c) foreign personal holding company income (FPHCo income), (2) amounts included in gross income as undistributed foreign personal holding company income under Sec. 551, and (3) income currently taxed in the hands of U.S. persons under Sec. 1293 as inclusions in gross income from Passive Foreign Investment Companies (PFICs) that have made a Qualified Electing Fund (QEF) election.

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9. Sec. 921(a).
10. Sec. 912(d).
11. Secs. 901(h), 923(a)(2) and 927(d)(4).
12. Sec. 904(d)(1)(A); Reg. Sec. 1.904-4(b).
13. Sec. 904(d)(1)(b); Reg. Sec. 1.904-4(d).
14. Sec. 904(d)(1)(C); Reg. Sec. 1.904-4(e) reserved pending Technical Corrections.
15. Sec. 904(d)(1)(D); Reg. Sec. 1.904-4(f).
16. Sec. 904(d)(1)(E); Reg. Sec. 1.904-4(g).
17. This basket has further been expanded to include distributions out of earnings and profits attributable to qualified interest and carrying charges (as defined in Sec. 245(c)).

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a. Definition of FPHCo income

FPHCo income, defined in new Sec. 954(c) consists of:

(1) Dividends, interest, rents, royalties and annuities, subject to certain exceptions.

(2) Net gains from sale of property giving rise to passive income of the type referred to in "a" above (or non-income property such as land held for investment or precious metals). Stock in trade, inventoriable property and property held by a dealer for sale to customers (Sec. 1221(1)) in the ordinary course of business is excluded from the category.

Reg. Sec. 1.904-4(b)(1)(A) makes it clear that any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under Sec. 1248 is to be treated as passive income.

(3) Net gains from commodity transactions, *other than* net gains from:
(a) reasonably necessary and customary bona fide hedging transactions of producers or sellers of commodities;
(b) active business gains by sellers of commodities, substantially all of whose business is as an active producer or seller of commodities;
(c) Sec. 988 foreign currency transactions in non-functional currencies (treated separately in 4 below).

(4) Net gains from certain (Sec. 988 transactions including futures and forward contracts) non-functional foreign currency transactions, unless directly related to the business needs of the taxpayer. Sec. 988 transaction net gains are essentially net gains realized by exchange rate changes from booking to payment date on debt instruments, expenses or receipts and certain forwards, futures or option contracts that are denominated in terms of a non-functional currency. (A "functional currency" is the U.S. dollar or the currency in which a qualified business unit's significant activities are conducted and recorded.[18])

The final Regulations (issued 15 July 1988) contain an example clarifying that the business needs exception extends to foreign currency gains made directly by a taxpayer (other than through a controlled foreign corporation (CFC)).

(5) Income "equivalent to interest" (including commitment fees for loans made).

b. Exceptions to FPHCo income

(1) *Active rents and royalties*

Rents and royalties derived in the active conduct of a trade or business from unrelated persons continue to fall outside the definition of FPHC income.[19]

(a) *Facts and circumstances test*
The determination of active vs. passive rents and royalties is primarily based on the "facts and circumstances" test of Reg. Sec. 1.954-2(d)(1) in relation to excluding rents and royalties as Subpart F income. In applying this test, the term "taxpayer" is to be substituted for CFC if the recipient of the rents or royalties is not a CFC.[20]

(b) *Affiliated group basis*
The Conference Committee Report (page 566) had indicated that forthcoming Regulations would likely include a more objective test and might in certain circumstances be applied on a consolidated group basis.

Reg. Sec. 1.904-4(b)(2)(ii) thus provides that the active trade or business requirement may be satisfied by either the recipient U.S. corporation or by a CFC or other corporation to which the look through rules apply that is a member of the affiliated group under Sec. 1504(a) without regard to Sec. 1504(b)(3) that includes the recipient.

(c) *Royalties earned by CFC*
Rents and royalties earned by a CFC are, under the final Regulations, treated in the same manner as those received by a domestic corporation.[21] The CFC need not perform activities that are an "essential economic element" with respect to royalties received (as originally proposed). A CFC receiving rents or royalties may satisfy the test with reference to the activities of its affiliates.

(d) *Related person*
The definition of a related person was changed by TRA 86 from a threshold test of "more than 50%" of total voting power to "50% or more" of total voting power or of value. The definition of a related person was extended to include controlled partnerships and other entities.[22] The Technical and Miscellaneous Revenue Act of 1988 has confirmed the related person definition to the general CFC rule ("more than 50%").[23]

For purposes of the active rents or royalties exception, this definition of related person is to be applied without regard to whether the relationship is between a CFC and another person or between 2 non-CFCs.

(2) *Certain export financing interest*

Export financing interest that is derived in the conduct of a banking business is excluded from FPHCo income.[24]

(3) *Same country exception for CFCs*

Dividends and interest received by a CFC from a related person organized and operating in the same country in which the CFC is organized, are not FPHCo income provided that the paying company has a substantial part of its assets used in a trade or business in such country. It is thus possible to have a holding company and an operating company in the same foreign country and not generate FPHCo income on intercompany dividends and interest.[25]

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18. Sec. 985(b)(1).
19. Sec. 954(c)(2)(A).
20. Sec. 904(d)(2)(H); Reg. Sec. 1.904-4(b)(2)(i).
21. Reg. Sec. 1.954(2)(d)(1).
22. Sec. 954(d)(3).
23. Id.
24. Sec. 954(c)(2)(b).
25. Sec. 954(c)(4).

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A banking or finance company may receive interest from a related banking or finance company that is FPHCo income provided the businesses of both companies are predominantly with unrelated persons.

Rents and royalties received from an affiliated company for the use of property in the same country as that in which the CFC is organized are also excluded from the FPHCo income category.

c. Exceptions to passive income

(1) *Other Sec. 904(d)(1) separate limitation income*

Passive income basket specifically excludes income subject to other separate limitation categories. Accordingly, passive income is of a kind which to a U.S. shareholder of a CFC would be included in income as Subpart F FPHC income. However, not all Subpart F FPHC income is included in the passive income basket, e.g. dividends received from 10% to 50% U.S. owned foreign corporations are treated under the "look through" rules discussed below as Sec. 902 corporation dividends.

High withholding tax interest and financial services income, together with other specifically listed separate limitation categories of income, are excluded from passive income.

(2) *Export financing interest (Sec. 904(d)(2)(G))*

(a) Export financing interest is excluded from passive income and falls into the overall basket.

(b) "Export financing interest" is defined as interest derived from financing the sale for use or consumption outside the United States of property manufactured, produced, grown or extracted in the United States by the taxpayer or a related person (similar to FSC "export property" definition in Sec. 927(a)). A related person is determined with reference to control (50% voting power or value ownership) under Subpart F rules[26] and includes a corporation controlled by the same person that controls the recipient of the export financing interest.

(c) Not more than 50% of the fair market value of the qualifying property (the appraised value for customs purposes) may be attributable to imported items.

(d) Interest income may arise that is export financing interest under Sec. 904(d)(2)(G) and is required to be treated as if it were interest on a loan to an obligor under a trade or service receivable under Sec. 864(d)(1). This might arise where a CFC derives income from a loan to finance the purchase of Sec. 1221(1) property of a related person or the payment for performance of services by a related person.[27] Alternatively, a CFC or non-CFC that derives income from the factoring of an export trade or service receivable from a related person (within the meaning of Sec. 267(b)) will be required to treat the income as interest from the obligor under the receivable under Sec. 861(d)(1).

Interest that is both export financing interest under Sec. 904(d)(2)(G) and Sec. 864(d)(1) deemed interest, will be treated as passive income. The final Regulations have reserved on interest of this kind received by a financial services entity.[28]

An exception applies for a foreign person that is not a financial services entity and receives or accrues interest or other income from a trade or service receivable acquired from a related person in the same foreign country as the recipient. The interest will be considered export financing interest in the overall basket while the other income will also be considered overall limitation income.[29]

New Sec. 904(d)(2)(A)(iv) was added by TAMRA 1988 which clarifies that in determining whether income would be foreign personal holding company income, the related person factoring rules under Sec. 864(d)(6) will only apply in the case of an actual CFC. Thus, income earned directly by a U.S. person may be eligible for the export financing exceptions under Sec. 904(d)(2).

(3) *High-taxed income (new Sec. 904(d)(2)(F))*

(a) *Kick-out mechanism*

A "kick-out" mechanism was instituted to ensure that low taxed income in the passive income basket does not benefit from the foreign tax credits associated with high taxed passive income. High taxed income that would otherwise be passive income shall be treated as general limitation income (the overall basket). Taxes imposed on that income are considered related to general limitation income.

(b) *Definition*

High taxed income includes any income (otherwise passive) if the effective foreign income tax rate exceeds the highest U.S. tax rate on the income (grossed up under Sec. 78). Both direct foreign income taxes paid or accrued and deemed paid foreign income taxes under Secs. 902 and 960 are included in the effective foreign income tax rate.

(c) *Expense allocations*

The effective rate test is done at the taxable income level (i.e. after allocating expenses at the U.S. recipient level).[30] Thus the Reg. Sec. 1.861-8 expense allocations to the passive income are done first to establish the effective foreign income tax rate for high taxed "kick-out" purposes.

(d) *Grouping*

The Conference Committee Report accompanying TRA 86 indicated that the grouping of individual items might be permitted by the Secretary for purposes of applying the kick-out rule. Factors influencing grouping were to be administrative convenience weighed against taxpayer averaging opportunities.

Grouping of all the passive income portion of a Subpart F income inclusion from a CFC was anticipated

26. Sec. 954(d)(3).
27. Sec. 864(d)(6).
28. Reg. Sec. 1.904-4(h)(3)(ii).
29. Reg. Sec. 1.904-4(h)(3)(v).
30. Conf. Rep. at 567.

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despite varying rates of tax on such income items.[31] However, it was indicated that grouping was unlikely to be permitted with respect to passive income Subpart F inclusions from different CFCs.[32]

Reg. Sec. 1.904-4(c)(2) contains the following rules for grouping items of income to determine whether passive income is high taxed income:

(1) *Expense allocations*
Expenses are required to be allocated and apportioned to each of the groups of passive income described below under the rules of Reg. Sec. 1.861-8. Passive interest expense may be allocated among the groups of passive income on a gross income basis even where interest expense is, in general, allocated and apportioned under the asset method.

(2) *Items of income received directly by a U.S. person*
Passive income received directly by a U.S. corporation from unrelated persons and from CFCs is grouped as follows:
(i) passive income subject to a withholding tax of 15% or more is treated as one item of income;
(ii) passive income subject to a withholding tax of less than 15% but greater than 0 is treated as one item of income;
(iii) passive income not subject to withholding tax is treated as one item of income.[33]

(3) *Subpart F inclusions and foreign branch earnings*
Passive income included under Subpart F or earned through a foreign QBU by a U.S. person is grouped as follows:
(i) inclusions with respect to each CFC and earnings from each foreign QBU together with each QBU of a CFC or other look through entity are to be separately identified;
(ii) with respect to each of the separate entities in (i) above, passive income of the foreign QBU (foreign branch or CFC) is to be divided into passive income from sources within that QBU's country of operation and from sources without the QBU's country of operation. Passive income from each of these separate sources is treated as one item of income;
(iii) passive income from sources without the QBU's country of operation is grouped on the basis of the withholding tax imposed on that passive income as in (2) above. The passive income to the foreign QBU is sourced under the laws of the foreign country of the payor of the passive income.[34]

(4) *Special rules*
The following special grouping rules apply:
(i) All items of rent or royalty income to which an item of rent or royalty expense is directly allocable (e.g. a CFC receiving royalties and, in turn, paying royalties to its parent) are to be treated as a single item of income and not grouped with other amounts;
(ii) A partner's distributive share of partnership income not subject to look through rules but categorized passive (a limited partner or general partner owning less than 10% of the value in a partnership) is treated as a single item of income. A distributive share of partnership income treated as passive under the look through rules is grouped as in (3) above;
(iii) Currency gains or losses on distributions out of PTI (recognized under Sec. 986(c)) that are categorized passive, are treated:
(a) as passive income subject to no withholding tax if received directly by the U.S. shareholder;
(b) as passive income from sources within a QBU's country of operation if received by a CFC or foreign QBU of the U.S. shareholder (applied separately for each foreign QBU of a U.S. shareholder and of a CFC).

(e) *CFC level*
The high taxed kick-out applies at the U.S. shareholder level only and not at the CFC level. Thus, for example, a passive royalty paid by a high taxed CFC to another CFC of the same parent would remain passive income to the second CFC.

(f) *Additional tax in year of receipt of PTI*
The high taxed kick-out may apply to foreign withholding taxes imposed on the distribution of passive income previously taxed under Subpart F to the extent that the withholding taxes render the total inclusion high taxed income.[35]

(1) *General rule*
The determination as to whether passive income included under Sec. 951(a) is high taxed income is to be made in the year of inclusion without regard to additional foreign taxes, e.g. withholding taxes, imposed on the ultimate distribution out of the CFC's PTI.

(2) *Exceptions*
The following exceptions apply to disregarding additional foreign taxes payable on distribution of PTI:
(i) additional foreign taxes arising from a Sec. 905(c) adjustment in the year of inclusion are to be considered;
(ii) distributions out of PTI received by the shareholder within 90 or more days prior to the day that the taxpayer files its return for the taxable year of the Sec. 951(a) inclusion of the E&P to which the distribution is attributable (the "prefiling period"). The U.S. shareholder must then consider all foreign taxes paid or accrued before the end of the prefiling period in applying the high taxed kick-out to the passive income Sec. 951(a) inclusion;
(iii) the U.S. shareholder may elect to consider additional foreign taxes paid or deemed paid or accrued after the prefiling period but before filing the return.[36]

Foreign withholding taxes imposed on distributions of previously taxed income made outside of the prefiling

31. Conf. Rep. at 568.
32. See example Conf. Rep. at 568.
33. Reg. Sec. 1.904-4(c)(3)
34. Reg. Sec. 1.904-4(c)(4).
35. Reg. Sec. 1.904-4(c)(6).
36. Reg. Sec. 1.904-4(c)(6)(ii).

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period and not subject to inclusion by election of the taxpayer before filing the return are allocated to either passive or overall limitation income as follows:
(1) If the passive income previously included under Sec. 951(a) was high taxed income, the additional foreign withholding taxes on the distribution will be allocated to the overall basket;
(2) If the passive income was previously included in the passive basket, not being high taxed income (without regard to the additional foreign withholding taxes), then the additional foreign taxes on the distribution may be allocated initially to the passive basket and thereafter to the overall basket in the following order:

(i) The taxes are allocated passive to the extent of: the highest Sec. 11 rate of tax times the Sec. 951(a) inclusion, divided by the foreign taxes deemed paid/paid in year of inclusion;
(ii) Taxes in excess of this amount are allocated overall. Currency losses associated with the distribution of PTI are not considered as increasing foreign tax, being a decrease in the volume of the CFC's E&P, not income.[37]

(g) *Reduction in foreign tax rate on distribution*
Certain integrated foreign tax systems, such as Germany and Japan, effectively reduce the rate of tax applied to earnings once distributed. A similar result ensues on United Kingdom earnings distributed to a U.S. parent company by way of ACT refund.

(1) *General rule*
In these circumstances, the high tax kick-out rules are applied at the time of a Sec. 951(a) inclusion without regard to possible reductions in tax on distribution. If the CFC subsequently distributes the PTI, and triggers a reduction in the rate or refund of foreign tax, provided a redetermination of the U.S. tax liability is required under Sec. 905(c), the taxpayer is required to redetermine whether the inclusion should be high taxed income.[38] Presumably similar rules apply to Sec. 1293 inclusions.

If the initial inclusion was allocated to overall income under the high taxed kick out but would not have been so treated taking into account the reduction in foreign tax, the taxpayer must redetermine its FTC for the years affected and treat the inclusion and taxes as falling within the passive basket. Sec. 905(c) principles apply to the redetermination.

(2) *Exception*
An exception applies to distributions out of PTI attributable to E&P of CFCs subjected to foreign taxes under an integrated system that are received within the prefiling period. The U.S. shareholder is to consider all foreign taxes paid or deemed paid after reduction for distribution to the end of the prefiling period with respect to the Sec. 951(a) inclusion.[39]

(3) *Allocation of foreign tax reductions*
Reductions in foreign tax are to be allocated among the separate categories in the same manner as taxes are allocated.[40] The reductions are allocated to prior year's taxes on a LIFO basis in the following order:
(i) to foreign taxes associated with PTI;
(ii) to foreign taxes associated with income that remained passive but met the "high taxed" exception for Subpart F;[41] and
(iii) foreign taxes associated with other earnings and profits.

Distributions out of PTI are considered to be made on a LIFO basis first out of earnings and profits previously included as a Sec. 956 investment; secondly, out of earnings and profits previously included under Subpart F; thirdly, out of earnings and profits remaining in the passive category but excluded from Subpart F under the high taxed exception and, finally, out of other earnings and profits.

(4) *Sec. 9554(b)(4) exception*
The high taxed income exception of Sec. 954(b)(4) (exclusion from foreign base company income if taxed at greater than 90% of the U.S. Sec. 11 rate) is to be applied without regard to the possibility of subsequent reductions of the foreign tax on distributions. If a taxpayer elects this exception, the income will remain passive in character until distribution when the high taxed kick-out rules will be applied.

(5) *Foreign oil and gas extraction income*
Foreign oil and gas extraction income is excluded from passive income.[42]

2. High withholding tax interest (Sec. 904(d)(2)(B))

This separate limitation was introduced to prevent high withholding tax loans being utilized to produce low taxed foreign source income to improve the overall FTC limitation.[43]

a. Definition

"High withholding tax interest" is defined as interest that is subject to a withholding tax (or other gross basis tax) of a foreign country or U.S. possession at a rate of 5% or more. A withholding tax is not considered to be determined on a gross basis unless it is the final tax payable on the interest income and not merely a prepayment or credit on a net basis tax.[44]

TAMRA 1988 amended Sec. 904(d)(2)(B)(iii) to clarify that a tax collected by a foreign taxing authority using a withholding type mechanism does not necessarily classify such tax as a gross-basis tax and thus subject to this rule.

b. Exception

Export financing interest is excluded from high withholding tax interest notwithstanding a high rate of withholding and falls into the overall basket (unless

37. Reg. Sec. 1.904-4(c)(6)(iii).
38. Reg. Sec. 1.904-4(c)(7).
39. Reg. Sec. 1.904-4(c)(8).
40. Reg. Sec. 1.904-6.
41. Sec. 954(b)(4).
42. Sec. 904(d)(2)(A)(iii)(IV).
43. The Senate Bill applied this separate limitation to banks, financial institutions and insurance companies only.
44. Reg. Sec. 1.904-4(d).

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received or accrued by a financial services entity, when it is financial services income).

c. Rules

(1) Any excess withholding tax over 5% that is imposed on interest received or accrued by a foreign corporation is not a deemed paid tax under Sec. 902 on a dividend from a non-controlled Sec. 902 corporation (i.e. a 10% to 50% U.S. owned foreign corporation) to the extent that it is paid out of high withholding tax interest.[45] Considerable practical difficulties may arise in obtaining foreign withholding tax information from non-controlled foreign corporations.
(2) Anti-avoidance regulations were to have been issued to treat amounts not otherwise meeting the definition of high withholding tax interest as such income.[46] The Proposed Regulations issued under Sec. 904(d) on 26 August 1987 contained limited anti-avoidance language with respect to high withholding tax interest.
(3) The rule applies to high withholding tax loans made by CFCs under the look through rules (see VI. below).
(4) The high withholding tax interest category takes precedence over passive income and financial services income categories. Accordingly, high withholding tax interest is excluded from both passive and overall baskets and, where appropriate, from the financial services income basket.
(5) Significant transitional rules apply for interest on loans to borrowers in 33 specified less developed countries (applies to loans held on 16 November 1985).

3. Financial services income (Sec. 904(d)(2)(C))

a. Definitions

(1) *Financial services income*

"Financial services income" is defined in Sec. 904(d)(2)(C) as any income which is received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing or similar business, and which is:
(a) derived in the active conduct of a banking, financial or similar business;
(b) derived from the investment of unearned premiums or reserves by an insurance company;
(c) insurance income (as defined in new Sec. 953(a)) without limitation to the insuring of risks in countries other than that in which taxpayer is created or organized).

(2) *Active financing income*

An apparently exhaustive list of income that was to be included as "income from the active conduct of a banking, insurance, financing or similar business" was contained in Proposed Reg. Sec. 1.904-6(e)(2)(A) to (X) (including "such other income as the Secretary may designate").

The Final Regulations reserve the definition of financial services income pending the Technical Correction that limited the financial services category to entities that are predominantly engaged in the active conduct of a banking, insurance, financing or similar business (active financing business). The Regulations did, however, contain a definition of "active financing income" that comprised an exhaustive list largely similar to the definition of "income from the active conduct of a banking, insurance, financing or similar business" contained in the Proposed Regulations. The list expanded upon certain categories and was changed to include related person insurance income. A new category was added for a similar item of income disclosed in the manner provided in the instructions to Forms 1118 or 1116 (in recognition of new financial products).[47]

An important exclusion from qualifying financial services income is income from "merely serving as a finance vehicle for a parent corporation or related person (as defined under Sec. 954(d)(3))". Group finance companies were thus not likely to generate financial services income unless independently performing financial service activities for profit. If the group finance company qualifies as a financial services entity, the income from acting as a financing vehicle for a related party is incidental income (see below).

(3) *Financial services entity*

A financial services entity means a person predominantly engaged in the active conduct of a banking, insurance, financing or similar business. The "predominantly engaged" requirement will be met for a year in which 80% of the entity's gross income (including excludible income) is qualifying financial services income. This determination is to be done on an entity-by-entity basis, but a domestic corporation that is not a financial services entity may qualify as a financial services entity if the affiliated group of which it is a member meets the 80% gross income test.[48]

Gain from the disposition of stock in a related corporation (under Sec. 267(b)) is excluded from the 80% test to prevent disqualification from a large one-time gain. Income from a related person that is financial services income under the look through rules is similarly excluded.

As a result of the proposed definition of a financial services entity, only persons predominantly engaged in the active conduct of a banking, insurance, financing or similar business would have been separated into the financial services basket. This was in accordance with the provisions of Technical Corrections Bill of 1987 which did not pass. The Regulations, as proposed, were therefore unauthorized in this respect and reserved in the final Regulations.

(4) *Partnership*

A partner's distributive share of a partnership that is a financial services entity and is subject to the look through rules (being a controlled partnership) will be

45. Sec. 904(d)(2)(E)(ii).
46. Sec. 904(d)(2)(B)(iii).
47. Reg. Sec. 1.904-4(e)(ii).
48. Reg. Sec. 1.904-4(e)(3)(i).

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treated as active banking, insurance, financing or similar business income for the 80% gross income test, regardless of whether the partner is a financial services entity (partnership income characterized under look through rules is excluded for this purpose). If the partnership is not a financial services entity, the character of the income to the partner will be that of the partnership income (look through income characterized as active financing income or other income will be considered for this purpose).

(5) *Incidental income*

Incidental income is income that is integrally related to the active financing income of a financial entity. Accordingly, the income from stocks acquired as an ordinary and necessary incident to conducting the banking business, for example, as seized collateral pledged against a loan, would be financial services income for the length of time that the retention of the stocks remains an ordinary and necessary incident to the conduct of the banking business. If held for 5 years or less, it is presumed to be incident to the financial services business. If held for more than 5 years, it is rebuttably presumed to not be incident (rebutted by showing it is not held as an investment). The income during the first 5 years remains financial services income even if the presumption (after 5 years) cannot be rebutted.

Incidental income includes income from acting as a financing vehicle for borrowing funds for a related person under Sec. 954(d)(3).

De minimis non-financial activity income of a financial services entity is not financial services income.

b. Exceptions

Excluded income categories that under the 1988 Act fall outside the financial services income basket are:
(1) export financing interest income that is not also high withholding tax interest (falls within overall basket);
(2) high withholding tax interest income that is not also export financing interest (falls within its own separate limitation basket);
(3) any dividend from a non-controlled Sec. 902 corporation.

c. Rules

(1) If an entity is predominantly engaged in the financial services business, any otherwise passive income will be considered financial services income. Similarly, shipping income that is also financial services income will be treated as financial services income. This rule permits continued cross crediting with respect to different types of financial service income (though not with respect to income unrelated to financial services).

(2) High withholding tax interest and export financing interest are subject to their own categorization rules even where the recipient satisfies the predominantly engaged test.

(3) The predominantly engaged test may, with respect to Subpart F inclusions from CFCs, be satisfied at either the U.S. recipient level or the CFC level. High withholding tax interest paid by a CFC out of financial services income would, under the look through rules, be financial services income. The 1987 Act modifies this look through rule so that the income remains high withholding tax interest.[49]

4. Shipping income (Sec. 904(d)(2)(D))

a. Definition

Shipping income is defined as any income of a kind which, if received by a controlled foreign corporation, would be foreign base company shipping income under Sec. 954(f). Such income does not include any dividends from a non-controlled Sec. 902 corporation and does not include any financial services income.

b. Rules

(1) Foreign base company shipping income that is reinvested is no longer excluded from foreign base company income.[50]

(2) Foreign base company shipping income includes income from a space or ocean activity (as defined in Sec. 863(d)(2)).

(3) Shipping income takes priority over the passive income category, but if income is both shipping income and also financial services income, it is included in financial services separate limitation basket.

(4) Shipping income does not include any dividends received or accrued from a non-controlled Sec. 902 corporation.[51]

5. Dividends from each non-controlled Sec. 902 corporation (new Sec. 904(d)(2)(E))

a. General

Dividends from non-controlled Sec. 902 corporations are not, in general, subject to a look through rule but are included in a separate basket with respect to each payor Sec. 902 corporation. The rationale behind this approach is that while it is generally appropriate to allow cross-crediting of taxes paid by one unit of a worldwide business against income earned by another unit of that business (and Subpart F inclusions out of the different CFCs may therefore be in the same basket if in the same income category on a look through basis), there is insufficient identity of interest among different non-majority ownerships of U.S. shareholders to permit cross-crediting with respect to non-CFC dividends. A look through rule would be practically unworkable owing to inaccessibility of information while the necessary allocation of expenses among Sec. 902 dividends is less cumbersome. Furthermore, the PFIC rules prevent, to a degree, cross crediting of taxes on active and passive income of a non-CFC,

49. Sec. 904(d)(3)(H).
50. Sec. 954(b)(2) and (g) repealed.
51. Reg. Sec. 1.904-4(f).

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without the need for a look through rule[52] as passive income is, in any event, subject to a U.S. tax charge.

b. Definition

A "non-controlled Sec. 902 corporation" is defined as any foreign corporation, other than a controlled foreign corporation, that meets the stock ownership requirements of Sec. 902 (with respect to 1st, 2nd and 3rd tier foreign corporations, where appropriate) to qualify for deemed paid credits on dividends, i.e. in general at least 10% voting stock (additional requirements for 2nd and 3rd tier: e.g. the 1st tier must own 10% of the voting stock of the 2nd tier *and* the percentage of the 1st tier owned by the U.S. parent multiplied by the percentage that the 1st tier owns of the 2nd tier must equal at least 5%).

(1) The separate limitation essentially applies to dividends from foreign corporations owned from 10% to 50%.

(2) It also applies to dividends from CFCs if paid out of earnings and profits accumulated in non-CFC years when the corporation has a non-controlled Sec. 902 corporation.

(a) Distributions from a CFC out of E&P attributable to a period when the CFC was neither a CFC nor a non-controlled Sec. 902 corporation are to be treated as dividends from a non-controlled Sec. 902 corporation (the Proposed Regulations treated it as passive).[53]
(b) Earnings and profits of an acquired foreign subsidiary earned while owned by a foreign parent would seemingly be non-CFC income when distributed.
(c) A Sec. 1248 dividend triggered by a Sec. 338 election if purchased from a foreign seller would also appear to fall into this basket (or series of baskets if multiple foreign corporations are purchased).
(d) Dividends distributed by a non-controlled Sec. 902 corporation out of E&P attributable to periods in which the shareholder did not meet the Sec. 902(a) or (b) ownership requirements is treated as a dividend from a non-controlled Sec. 902 corporation.
(e) The final Regulations reserved on the treatment of inclusions under Sec. 1293 (QEFs).

c. Rules

(1) The foreign withholding taxes and deemed paid foreign taxes on the Sec. 902 dividend income in excess of the U.S. tax imposed on the dividends give rise to a carryover and carryback of excess credits on a company-by-company basis.

(2) Dividends from 10% or more owned non-CFCs to a CFC will, under the look through rules, generally fall within the Sec. 902 dividend separate limitation basket where there is a Subpart F inclusion or dividend distribution (or interest, rent or royalty payment) to the U.S. parent from the CFC.

Where only one of 2 U.S. shareholders of a CFC that owns stock in a foreign corporation meets the Sec. 902(b) ownership requirements, the dividends from the foreign corporation to the CFC are treated as dividends from a non-controlled Sec. 902 corporation in their entirety. The shareholder not meeting the Sec. 902(b) ownership requirements is to treat its income attributable to the Sec. 902 dividend received by a CFC as passive income.[54]

(3) The same country exception[55] to Subpart F income, i.e. dividends or interest to a CFC from certain related persons (50% or more owned by CFC) in the same foreign country, does not prevent the separate company limitation rule applying to a dividend paid out of the CFC from E&P attributable to the intercompany dividend.

(4) The Subpart F de minimis rule[56] applies to non-CFC dividends received by a CFC, i.e. no Subpart F inclusion and application of separate limitation currently unless sufficient Subpart F income.

(5) Dividends from non-CFCs, out of E&P attributable to high withholding tax interest are subject to a special rule that disallows as a Sec. 902 deemed paid foreign tax credit withholding taxes imposed on the underlying interest to the extent exceeding a 5% rate. (This rule has no impact on the determination of the E&P of a non-controlled Sec. 902 corporation.)[57]

(6) Look through rules are preserved for dividends from non-CFCs out of high withholding tax interest and foreign oil and gas extraction income to prevent cross crediting of high taxes on these categories of income against U.S. tax on low taxed income. Practical difficulties are likely in applying these rules.

(7) Look through rules also apply to more than 25% not more than 50% owned insurance companies under Sec. 957(b) (as amended) and to captive insurance companies under new Sec. 953(c), that are CFCs for Subpart F purposes (to preserve conformity with the Subpart F and look through rules).

6. Foreign oil and gas extraction income

The rules of Reg. Sec. 1.904-4 together with the rules of Sec. 907(c) are to be applied to foreign oil and gas extraction income.[58] Thus dividends from 2 separate non-controlled Sec. 902 corporations out of E&P attributable to foreign oil and gas extraction income (FOGEI) will be separately subjected to the reduction in foreign taxes under Sec. 907(a) with respect to the dividends received from each non-controlled Sec. 902 corporation.

7. Reg. Sec. 1.985-3(d)(2) currency gains and losses

Reg. Sec. 1.985(d)(2) currency gains and losses are to be allocated among the categories based on foreign

52. Conf. Rep. at 582.
53. Reg. Sec. 1.904-4(g)(3).
54. Reg. Sec. 1.904-4(g)(2)(ii).
55. Sec. 954(c)(3).
56. Sec. 954(b)(3).
57. Reg. Sec. 1.904-4(g)(2)(iii).
58. Reg. Sec. 1.904-4(i).

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source income in each category before application of the high tax "kick out" from passive income.[59]

8. Priority rules

Reg. Sec. 1.904-4(k) reserved on the priority rules that were contained in the Proposed Regulations which provided that income that fell within more than one separate limitation basket was subject to the following priority rules:

(a) if in the passive and another basket, treated as in the other basket;
(b) if in the financial services basket and also in either the shipping or passive income basket, treated as in the financial services basket;
(c) if in the financial services basket and also in a basket other than the shipping or passive income basket, treated as in the other basket;
(d) if in the non-controlled Sec. 902 dividend basket and also in any other basket, treated as in the non-controlled Sec. 902 dividend basket;
(e) if in the high withholding tax interest basket and another basket, treated as in the high withholding tax interest basket.[60]

VI. LOOK THROUGH RULES FOR INCOME FROM CONTROLLED FOREIGN CORPORATIONS (NEW SEC. 904(d)(3))

A. General

The intent of the look through rules is to treat, for purposes of the foreign tax credit limitation, income earned through foreign branches and foreign subsidiaries "more alike", as if earned directly by the U.S. parent.[61]

The look through rules, in general, apply only to Sec. 957 CFCs (including certain U.S. owned and captive insurance companies). "United States shareholder", for purposes of the look through rules, includes any member of the controlled group of the U.S. shareholder.

The final Regulations under Sec. 904(d) extend the application of the look through rules to provide that interest, rents and royalties received by 10% U.S. interest holders in partnerships are characterized under the look through rules (under the principles of Reg. Sec. 1.861-8), provided the partner owns 10% or more of the value of the partnership and look through rules would have applied if it were a foreign corporation. (The 10% value test is applied with respect to capital and profits interests.) A partner's distributive share is characterized with reference to the underlying partnership income. Sec. 707 payments to a partner are to be characterized as if the partnership were a foreign corporation. The distributive share of income and deductions of partners owning less than a 10% beneficial interest shall be passive income. An exception applies for a less than 10% interest held in the ordinary course of a partner's active trade or business (a similar trade or business).[62]

The proposed Regulations had considered further extending the rules to foreign source interest, rents or royalties received by 10% U.S. shareholders from U.S. companies that derive at least 80% of their gross income from sources outside the U.S. attributable to the active conduct of a trade or business in a foreign country.[63] This proposal was not contained in the final Regulations.

The rules aim at harmonizing the operation of the Subpart F and separate limitation look through rules.

There will generally be conformity between the separate limitation look through rules and Subpart F rules, i.e. the look through rules will apply to Subpart F inclusions from CFCs with respect to all Sec. 954(c) FPHC income, all foreign base company shipping income and some financial services income but not with respect to other separate basket income. Thus not all Subpart F (passive) FPHC income ends up in the passive basket, e.g. Sec. 902 dividends and not all separate basket look through income gives rise to Subpart F inclusion, e.g. active financial services income to predominantly engaged CFC.

B. Rules

1. General rule

The general rule provides that dividends, interest, rents and royalties received by the taxpayer from a CFC in which the taxpayer is a U.S. shareholder (as defined for Subpart F purposes) shall not be treated as separate category income but as general limitation income.

Thus for limitation purposes the income is not categorized based on the superficial category of the income received by the U.S. shareholder but, to the extent specified, based on the underlying category of CFC income out of which paid. Interest, rents and royalties on the one hand and dividends on the other have specified rules for categorizing the underlying income. The objective[64] is to treat income earned through a CFC as if earned directly by the U.S. parent.

Income shall be considered to fall within a separate category to the extent that it is properly allocable to the CFC in such category. Separate category means any category of income described in Sec. 904(2)(A)-(E), except that the determination of whether any amount is high taxed income will be made after the application of the look through rules to the CFC.

2. Subpart F income inclusions

Inclusions under Sec. 951(a)(1)(A), plus any gross up under Sec. 78 for deemed paid foreign taxes (treated as increasing Subpart F inclusion), are treated as having the same character as the underlying income of the CFC.

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59. Reg. Sec. 1.904-4(j).
60. Proposed Reg. Sec. 1.904-6(j).
61. Conf. Rep. at 573.
62. Reg. Sec. 1.904-5(h).
63. Proposed Reg. Sec. 1.904-7(h).
64. Conf. Rep. at 578.

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The priority rules of Reg. Sec. 1.904-5(k) apply where income is received from a related person that also receives income from the recipient and to which the look through rules apply.

(a) *Example:* Subpart F income consists of $ 100 of interest and $ 200 of foreign base company sales income. At the U.S. shareholder level, $ 100 of the Subpart F income included under Sec. 951(a)(1)(A) falls into the passive income basket (unless it is high withholding tax interest) and $ 200 falls into the overall limitation.[65]

(b) If, in the preceding example, the CFC paid $ 100 of interest to its U.S. shareholder (or to a related CFC) such interest payment is first netted against the CFC's gross Subpart F FPHC income that is passive, thus eliminating a Subpart F inclusion and causing such interest to be passive income to the recipient (or high withholding tax interest, if appropriate).[66]

The Conference Committee Report[67] notes that the amendment of the Subpart F chain deficit rule,[68] modification to the accumulated deficit rule and the required recapture of Subpart F income currently eliminated by non-Subpart F deficits are, in part, aimed at preserving the integrity of the separate limitation baskets.

(c) Sec. 904(g)(2) resourcing rules apply to treat as U.S. source income that portion of the Subpart F inclusion attributable to income of the CFC from U.S. sources in the separate category to which the inclusion is allocated. In order to determine U.S. source income in each separate category, the principles in "5.g" below apply.[69] The application to non-CFCs is not addressed in these rules.

3. Interest

Interest received or accrued from a CFC by a U.S. shareholder is treated at the U.S. shareholder/recipient level as having the character of the income of the CFC to which the CFC's deduction for such interest is allocable (under Regulations prescribed by the Secretary).

a. Interest netting rule

(1) An interest netting rule applies for both Subpart F and foreign tax credit limitation purposes. The purpose of the netting rule is to avoid creating an incentive for taxpayers to keep or move passive income or investments offshore[70] in order to take advantage of favorable allocation of the interest expense to effect a cross crediting of foreign taxes.

Interest paid or accrued by a CFC to one or more of its U.S. shareholders or a related CFC is "related person interest", and is allocable first to gross Subpart F foreign personal holding company income of the CFC that is passive income thus relieving Subpart F income otherwise includible under Sec. 951(a)(1)(A).[71]

The final Regulations, in contrast to the Proposed Regulations, provide that the allocation of related person interest expense of a CFC is allocated to separate categories prior to non-interest expenses not definitely related and unrelated person interest expense not definitely related (to avoid the creation of passive losses and to treat passive investments funded by a related person debt as direct investments of the related person). Furthermore, non-definitely related expenses other than interest and non-definitely related third person interest are allocated under one step (the Proposed Regulations contained 2 separate steps for these items). Finally, the final Regulations provide rules for allocating expenses to separate categories when the CFC allocates interest expense under the gross income method (reflecting the anticipated adoption of this alternative under Reg. Sec. 1.861-8).

Reg. Sec. 1.904-5(c)(2) provides the following rules for allocating "related person interest" and other expenses of a CFC:

(a) Gross income is determined in each category;
(b) Definitely related expenses (including unrelated person interest directly allocated to income from a specific property) are allocated and apportioned under Reg. Sec. 1.861-8 to each category;
(c) Related person interest is allocated to passive FPHCo income to the extent thereof;
(d) The excess of related person interest over passive FPHCo income is allocated under the formula:

$$(a - b) \times \frac{c}{d}$$ where

a = Related person interest
b = Related person interest allocated to passive FPHCo income
c = Value of assets in a separate category (non-passive)
d = Value of all assets (non-passive)

(e) Unrelated person interest not directly allocated and other expenses not directly related are allocated to each category under the following respective formulae:

(1) if the taxpayer uses the gross income method of apportionment

$$E \times \frac{GSC - RPD}{TG - RPI}$$ where

E = Expense
GSC = Gross income in a separate category
RPD = Related person debt allocated to category (if passive)
TG = Total gross income
RPI = Related person interest allocated to passive income

65. Conf. Rep. at 576, example 1.
66. Conf. Rep. at 578.
67. Conf. Rep. at 577.
68. Sec. 952(d).
69. Reg. Sec. 1.904-5(m).
70. Conf. Rep. at 578.
71. The interest "netting rule" was added to Sec. 954(b)(5) and categorized as Sec. 904(d)(2) passive income under the look through rules.

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(2) if the taxpayer uses the asset method of apportionment

$$E \times \frac{VSC - RPD}{VT - RPA} \text{ where}$$

E = Expense
VSC = Value of assets in a separate category
VT = Value of total assets
RPD = Related person debt allocated to category (if passive)
RPA = Related person debt allocated to passive assets

The value of assets and gross income in any category is determined under Reg. Sec. 1.861-8 principles, and is reduced by the principal amount of any indebtedness to the extent that the interest on the indebtedness is definitely related and allocated to income in that category. The reduction in the value of assets for allocated indebtedness associated with related person interest is made before determining average asset values.

Related person debt is allocated to passive assets as follows:

$$\text{Total related person debt} \times \frac{\text{Related person interest allocable to passive income under (c) \& (d) above}}{\text{Total related person interest}}$$ [72]

(2) The Secretary is empowered to extend the "netting" rule to payments and accruals of interest to unrelated persons by way of Regulations.[73]

(3) Sec. 904(d)(5) enables the Secretary to prescribe "such Regulations as may be necessary or appropriate" for the application of the look through rule. Netting might be required for rents and royalties paid by CFCs when cross crediting advantages otherwise result.

(4) The netting rule applies equally to the Sec. 904(g)(3) U.S. source maintenance rule. Related person interest expense allocated to CFC FPHC income that is therefore passive look through income will be U.S. source income to the parent if the CFC interest netted is passive U.S. source income.[74]

If related person interest is less than passive income, it will be allocated to U.S. source in the ratio of U.S. source passive income to total passive income. If more than passive income, the related person interest allocated to a category other than passive income is U.S. source to the extent below:

(a) *If the gross income method is used*

$$\text{Separate category interest (other than passive)} \times \frac{\text{Gross income from U.S. source in that category}}{\text{Gross income from all sources in that category}}$$

(b) *If the asset method is used*[75]

$$\text{Separate category interest (other than passive)} \times \frac{\text{Value of domestic assets in that category}}{\text{Value of total assets in that category}}$$

4. Rents and royalties

Rents and royalties received from a CFC by a U.S. shareholder are treated as separate category income by the U.S. shareholder to the extent allocable to income of the CFC in that category under Reg. Sec. 1.861-8.[76]

5. Dividends

Dividends paid out of the E&P of a CFC, including any gross up under Sec. 78, are treated as coming pro rata, from the separate category earnings and profits of the CFC in the ratio of separate category E&P to total E&P of the CFC.

a. Investment in U.S. property

Included in the dividend look through category are income inclusions under Sec. 951(a)(1)(B) for increases in earnings invested in U.S. property under Sec. 956 (not treated as Subpart F look through inclusion as drawn pro rata from earnings and profits like dividends).[77]

b. Categorization of E&P

Absent specific earnings and profits cut-off rules (e.g. Sec. 1248(d) limited to post 1976 E&P; Subpart F limited to post 1962 E&P) classification of all post 1913 earnings and profits into separate categories is required. This is consistent with the existing law rules requiring unlimited E&P recognition for Sec. 956 inclusions.

c. Sale of foreign subsidiaries

Sec. 1248 deemed dividends are included in the dividend look through category.

d. Foreign investment companies

Sec. 1246 ordinary income from the sale of shares in a foreign investment company is passive income and not subject to the dividend look through rule.

e. Distributions out of related person loans

The final Regulations introduced a special rule for dividends from a CFC out of loan proceeds from a related look through entity. The dividend is to be characterized with respect to the E&P of the related person lender.[78]

f. Related CFCs

The TRA 86 Conference Committee Report provided that Regulations were to be prescribed applying the look through rules to income paid or loans made through one or more entities or between 2 or more chains of entities. A colloquy between Senators Bradley and Danforth[79] confirmed that the look through Regulations were to provide that dividends, Subpart

72. Reg. Sec. 1.904-5(c)(2)(ii) and (iii).
73. Sec. 954(b)(5).
74. Reg. Sec. 1.904-5(m)(2).
75. Reg. Sec. 1.904-4(m)(2).
76. Reg. Sec. 1.904-5(c)(3).
77. Reg. Sec. 1.904-5(c)(4).
78. Reg. Sec. 1.904-5(c)(4)(ii).
79. Cong. Rec. of 27 September 1986 at 5 13950.

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F inclusions, interest, rents and royalties received by a CFC from another affiliated CFC shall be treated as separate category income under the look through rules only if directly or indirectly attributable to separate category income of any other member of the group.

The Final Regulations therefore provide that the look through rule is to be applied to the income of the related CFC and the income received allocated with respect to the related CFC's income categories where distributions or loans are made by the related CFC to the dividend paying CFC.

Two CFCs are considered related if either one CFC directly or indirectly owns more than 50% of the total voting power or value of the other CFC or the same U.S. shareholders own 50% or more of the total voting power or value of each CFC. Distributions or payments from a related CFC to another are subjected to the look through rules to the distributing CFC's income.[80] Loans to a CFC from a related person for the purpose of altering the characterization of a dividend for Sec. 904(d)(3)(D) will result in the dividend being characterized, to the extent of the principal amount loaned, with respect to the E&P of the related person (see "e" above). The related CFC look through rules of the Proposed Regulations have been expanded to include other "look through entities" in the final Regulations (e.g. certain partnerships).

g. Previously taxed income (PTI)

Dividends out of CFCs from income previously taxed under Subpart F are treated as Sec. 959(d) previously taxed income (PTI). These distributions out of PTI are thus excluded from both numerator and denominator, i.e. separate limitation E&P to total E&P, in applying the dividend look through rule to CFC dividends.

h. Sec. 904(g) resourcing rules

Sec. 904(g)(4) resourcing rules (a dividend paid by a U.S. owned foreign corporation is treated as U.S. source income to the extent of the U.S. source ratio of the U.S. source E&P to total E&P) apply to the separate foreign tax credit limitation categories in the ratio of U.S. source to total E&P of the CFC in each category. Separate category, U.S. source E&P is determined as follows:

(1) Related person interest is allocated to U.S. source income as in "3.a(c)" above;
(2) Other expenses are allocated by applying the rules in "3.a" above separately to U.S. source and foreign source income in each category.[81]

The deemed paid foreign tax credits associated with separate category U.S. source income, when treated as a dividend under Sec. 78, are included as U.S. source income.

The final Regulations reserved on the coordination of the Sec. 904(g) rules with treaties. The Proposed Regulations provided that U.S. source income under Sec. 904(g) treated as foreign source income under treaty provisions be subject to separate application of Secs. 902, 904, 907 and 960 with respect to each treaty under which benefits are claimed.

The 1988 Act provides new treatment for any amount derived from a U.S.-owned foreign corporation that the statute would treat as U.S. source income but the taxpayer, pursuant to a U.S. income tax treaty, treats as foreign source income. The taxpayer's inclusion will be treated as foreign source income subject to a separate foreign tax credit limitation. It is anticipated that the IRS may allow grouping of items that are similarly taxed by a foreign country.[82]

i. Order of application of Sec. 904(d), (g)

The above sections are to be applied in the following order to determine the FTC limitation:

(1) Sec. 904(d)(1) is applied to the CFC to determine its separate category E&P;
(2) U.S. source, separate category E&P is determined;
(3) Sec. 904(d)(3) look through rules and Sec. 904(g) resourcing rules at the shareholder level with respect to characterizing and sourcing the E&P of the CFC.[83]

j. Ordering rules for income from a related person that receives income from the recipient

A person that receives income from a related person where the payor also receives income from the recipient and the look through rules apply characterizes the income received in the following order:

(1) Rents and royalties;
(2) Interest;
(3) Subpart F inclusions and distributive shares of partnership income;
(4) Dividend distributions.

Income received is characterized before the income paid.

An interest netting rule applies to interest paid to and received from a related person prior to the ordering rule above.[84]

k. Modification of look through rules

(1) Interest from a CFC that is attributable to financial services income under the look through rules but would be high withholding tax interest in the absence of the look through rules, is treated as high withholding tax interest but limited to the interest of the payor that would be financial services income under the look through rules.

(2) Income from a CFC attributable to non-controlled Sec. 902 corporation dividends is treated as non-controlled Sec. 902 dividend income.

(3) Distributions from an FSC are treated as falling within their own category (although partly foreign trade income, partly passive under look through rules).[85]

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80. Red. Sec. 1.904-5(i).
81. Reg. Sec. 1.904-5(m)(2).
82. Sec. 904(g)(10).
83. Reg. Sec. 1.904-5(h).
84. Reg. Sec. 1.904-5(k).
85. Reg. Sec. 1.904-5(f).

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I. Subpart F income in excess of 70% of a CFC's gross income

The treatment of all gross income of a CFC as foreign base company income under Sec. 954(b)(3)(B) does not affect its character for Sec. 904(d) purposes.[86]

6. Passive Foreign Investment Company inclusions

The application of look through rules to PFIC inclusions has been reserved in the final Regulations.[87]

C. Exceptions

1. De minimis exception (Sec. 904(d)(3)(E))

The look through rules for dividends, interest, rents and royalties will not apply if the CFC meets the de minimis rule of Sec. 954(b)(3)(A). To fall under the rule, foreign base company and gross insurance income must be smaller than the lesser of 5% of gross income, or $ 1 million. The CFC is then treated as having no includible foreign base company income. Thus, in a taxable year of the CFC in which the de minimis test is met, none of its foreign base company income and none of its gross insurance income for such taxable year shall be treated as separate category income.

(a) The foreign loss allocation rules ("IX" below) do not apply to the CFC's income for the year the de minimis exception applies. This rule presumably preserves such current year E&P from further separate categorization in the event of a subsequent year dividend. In effect, annual E&P determinations are still required.

(b) Failure of the de minimis rule will result in application of the look through rules, even though Subpart F income is not reportable due to meeting the "not availed of" test of Sec. 954(b)(4).[88]

(c) Failure of the de minimis rule will generally taint all amounts of separate category income. *Example:* A CFC has $ 1 million of foreign base company sales income and $ 1 of bank account interest. The de minimis test does not apply and the $ 1 of bank account interest falls into the passive income basket at the CFC level.

(d) The final Regulations reserved on application of the de minimis rule to Subpart F income.

2. "Not availed of" exception (Sec. 904(d)(3)(E))

Only for purposes of the dividend look through rule, passive income of the CFC will be treated as *overall limitation* income if:

(a) subjected to an effective foreign tax rate greater than 90% of the U.S. maximum tax rate; and
(b) excluded from Subpart F foreign base company income and insurance income under Sec. 954(b)(4) (by election).

This rule has no effect on amounts other than dividends paid by CFCs to the extent allocable to passive income of the CFC.[89]

The "not availed of" exception therefore applies to passive, financial services and shipping income to harmonize Subpart F and the separate limitation look through rules.

VII. ALLOCATION OF FOREIGN TAXES TO SEPARATE BASKET INCOME: PROP. SEC. 1.904-8

A. General rules

An essential aspect of the FTC separate limitation rules is the allocation of taxes to the separate categories of foreign source income. Little consideration was given to this important aspect in the legislative history of the changes made to Sec. 904(d) by TRA 86. Reg. Sec. 1.904-6 provides comprehensive guidance in this respect.

1. Taxes related to income

Generally, the amount of taxes paid or accrued with respect to a separate category of income includes only those taxes that are related to the income in the separate categories. Taxes are related to income if the income is included in the base upon which the tax is imposed.

Recognition is given to using foreign tax rules to associate foreign taxes with the foreign income, e.g. no taxes are considered to be related to foreign exempt income. Specific foreign law rates of tax are considered, such as a capital gains tax. A withholding tax is related to the income from which it is withheld.

2. Taxes related to several categories of income

Taxes imposed on a base including more than one separate category of income are considered related to all such categories. The following formula is then applied on an annual basis to determine the amount of tax paid or accrued with respect to each separate category:

$$\text{Foreign taxes related to more than one separate category} \times \frac{\text{Net income subject to that foreign tax included in a separate category}}{\text{Net income subject to that foreign tax}}$$

Separate category net income and total net income are determined as follows:

Step 1. Determine gross income under the law of the foreign country or U.S. possession to which the foreign income taxes have been paid or accrued.

Step 2. Reduce gross income, as determined under foreign law, in the passive category by related person interest expense allocated under the netting rule ("3.a" above) to derive adjusted gross passive income.

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86. Reg. Sec. 1.904-5(e).
87. Reg. Sec. 1.904-5(j).
88. Conf. Rep. at 577, example 3.
89. Reg. Sec. 1.904-5(d)(2).

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Step 3. Deduct credits, expenses, losses and other deductions specifically allocable to the separate category gross income (including adjusted gross passive income) under the laws of the foreign country or possession. If the foreign law does not provide for such specific allocation, expenses are apportioned under foreign law principles after adjusting passive income by the interest netting rule. If foreign law does not provide for the apportionment of expenses, the principles of Secs. 1.861-8 and 954(b)(5) shall apply. However, in applying Sec. 1.861-8, all expenses, even interest expense, may be allocated under the gross income method and expenses need not be apportioned on other than a separate company basis.[90]

3. Apportionment of taxes for high tax "kick-out"

Taxes allocated and apportioned in "1" and "2" above are further apportioned to the groups of income determined under the grouping rules for high tax kick-out purposes. Taxes are related to the groups under the above rules (e.g. foreign law principles).

4. Dividends from Sec. 902 non-controlled corporations

Taxes will be allocated to dividends from Sec. 902 non-controlled corporations under the above principles. However, in the event of an express or implied agreement that such a dividend is paid out of a designated pool of earnings, then only the foreign taxes imposed on that pool of earnings will be considered related to the dividend.

B. Application to Secs. 902 and 960

For purposes of computing the DPFTC of U.S. shareholders of a CFC under Secs. 902 and 960, the portion of taxes allocated to a particular separate category that shall be deemed paid by the U.S. shareholder is determined as follows:

Sec. 902

$$\text{Separate category deemed paid FTC} = \text{Taxes allocated to separate category} \times \frac{\text{Sec. 902 dividend}}{\text{Sec. 902 E\&P}}$$

Sec. 960

$$\text{Separate category deemed paid FTC} = \text{Taxes allocated to separate category} \times \frac{\text{Sec. 951 inclusion}}{\text{Sec. 964 E\&P}}$$

For purposes of the Sec. 78 gross up, deemed paid taxes under Secs. 902 and 960 shall be treated as a dividend comprising income in the same separate category to which the taxes were allocated.

The foreign taxes deemed paid are to be computed from multi-year pools of E&P maintained for each category of income in Sec. 904(d)(1).[91]

VIII. FOREIGN TAX REDETERMINATION FOR PURPOSES OF FOREIGN TAX CREDIT

Temporary Regulations under Sec. 905 were issued on 22 June 1988 relating to notification and adjustment due to foreign tax redeterminations for purposes of foreign tax credits for taxable years beginning after 31 December 1986.

A. The redetermination applies to
1. tax that is paid or accrued by or on behalf of a taxpayer; or
2. tax that is deemed paid or accrued by a taxpayer under Sec. 902 or 960 with respect to E&P of a foreign corporation.

B. The term foreign tax redetermination means a change in the foreign tax liability that may affect a U.S. taxpayer's foreign tax credit, including
1. a refund of foreign taxes;
2. a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid or attributable to differences in the units of foreign currency paid and the units of foreign currency accrued; or,
3. a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

C. Redetermination of U.S. tax liability is required to account for a redetermination of foreign taxes directly paid by a U.S. person. The redetermination requires a notification to the IRS pursuant to Reg. Sec. 1.905-4T(b) and is effective for the taxable year for which credit was claimed for the foreign tax.

D. A redetermination of U.S. tax liability is *not* required, however, if the foreign tax redetermination is caused solely by a foreign currency fluctuation, and the amount of tax redetermination with respect to the foreign country is less than the lesser of $ 10,000 or 2% of the total dollar amount of the foreign tax initially accrued with respect to that foreign country for the taxable year.

E. A redetermination of U.S. tax liability is not required to account for the effect of a redetermination of foreign tax paid or accrued by a foreign corporation on the foreign taxes deemed paid by a U.S. corporation under Sec. 902 or 960.

The following exceptions apply:
1. A redetermination of U.S. tax liability is required if the foreign tax liability is in a hyper-inflationary currency.[92]
2. A redetermination of U.S. tax liability may be required if the amount of foreign tax accrued in the foreign currency exceeds the amount of foreign tax paid by at least 2%.
3. A redetermination of U.S. tax liability is required if a foreign tax redetermination occurs with respect to foreign taxes deemed paid with respect to a Subpart F inclusion or an actual distribution which

90. These rules do not impact the calculation of the foreign tax credit limitation and relate only to the allocation or the apportionment of taxes among separate categories of income.
91. Notice 88-71.
92. Reg. Sec. 1.905-3T(d)(4)(i).

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has the effect of reducing below zero the distributing foreign corporation's pool of foreign taxes in any separate category.

F. In lieu of a redetermination, appropriate adjustments are required to be made to the pool of foreign taxes and the pool of earnings and profits of a foreign corporation to reflect the effect of the foreign tax redetermination in calculating foreign taxes deemed paid with respect to distributions and inclusions.

If an adjustment to the appropriate pool of foreign taxes and E&P is required, notice must be given to the IRS.[93]

G. If a foreign corporation is required to adjust its E&P and foreign taxes, it must be done in accordance with Reg. Sec. 1.904-3T(d)(3).

1. A foreign corporation shall reduce its pool of foreign taxes in the appropriate separate category by the U.S. dollar amount of a foreign tax refund.

2. A foreign corporation shall increase its pool of foreign taxes in the appropriate separate category by the U.S. dollar amount of the additional foreign taxes paid or accrued.

3. If a lower tier foreign corporation receives a refund of foreign tax after making a distribution to an upper tier foreign corporation and the refund would have the effect of reducing below zero the lower tier corporation's pool of foreign taxes, then both the lower and upper tier corporation shall adjust the appropriate pool of foreign taxes to reflect the refund.

H. Currency translations rules of foreign tax redetermination under Reg. Sec. 1.905-5T:

1. Foreign taxes paid in foreign currency that are paid or deemed paid under Sec. 960 or 902 shall be translated into dollars at the rate of exchange for the date of the payment of the foreign tax. Refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the refund.

2. Foreign taxes deemed paid under Sec. 902 with respect to an actual dividend and refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the distribution of the earnings to which the taxes relate.

IX. TRANSITION RULES

The following rules govern the carryforward and carryback of foreign tax credits between pre and post-effective dates:

A. Sec. 904(d)(2)(I)

1. Carryforwards

Generally, pre-effective date excess credits can be carried forward to post-effective date years only to reduce U.S. tax on income of the old-law limitation category they had been in.

a. *Overall to overall*

For example, pre-effective date foreign taxes on portfolio (non-CFC Sec. 902) dividend income that are carried to a post-effective date year can offset U.S. tax only on overall limitation income in that later year since such income was overall limitation income in the pre-effective date year.[94]

b. *Exception*

There is an exception to the rule that pre-effective date excess credits on overall limitation income are generally carried forward to post-effective date overall limitation income. Overall limitation credits can be carried forward to post-effective date years to reduce U.S. tax on financial services income or on shipping income, provided that the taxpayer can establish that the taxes were paid on pre-effective date income in those categories.

c. *Separate interest to passive*

Credits on pre-effective date separate limitation interest can offset U.S. tax on post-effective date passive income.[95]

d. *Continuing limitation baskets*

Credits in baskets existing both before and after the effective date are carried forward in these baskets.

2. Carrybacks

Post-effective date excess credits can be used in pre-effective date years to reduce the U.S. tax on overall limitation income only. Post-effective date credits that are excess credits solely because of the rate reduction under the legislation cannot be carried back to higher rate years, i.e. the excess credit resulting from the rate reduction from 46% to 34%. Regulations are to be prescribed requiring adjustments to be made to the rule limiting carrybacks to take account of changes in the treatment of capital gains. In order to preserve the effect of the separate limitation for high withholding tax interest, post-effective date credits for high withholding taxes on interest cannot be carried back to pre-effective date years.

B. Advance Notice 87-6

On 24 December 1986 the IRS released Advance Notice 87-6 dealing with foreign tax credit transition rules. The Notice (authoritative through not binding) provisions include, among others, the following guidelines:

1. The look through rules apply to distributions and Sec. 951 inclusions from CFCs, out of E&P derived during the CFC's first taxable year after 31 December 1986 regardless of the taxable year of the recipient shareholder.

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93. Reg. Sec. 1.904-3T(2)(iii).
94. Sec. 904(d)(2)(I)(ii).
95. Sec. 904(d)(2)(I)(i).

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2. Distributions or Sec. 951 inclusions out of pre-1987 E&P of CFCs in post-1986 taxable years of payor and recipient are initially characterized at the CFC level under the pre-TRA 86 rules, then recharacterized at the distributee level applying Sec. 904(d)(2)(I) transition rules.

The following transition rules apply to the computation of Secs. 902 and 960 FTCs:

a. The 60-day rule is not applicable to dividends paid during the first 60 days of the foreign corporation's first taxable year beginning after 31 December 1986;

b. Pre-1987 E&P accumulated by a foreign corporation together with associated deemed paid foreign taxes under Sec. 902 or 960 are to be determined and translated into dollars under pre-TRA 86 rules regardless of the taxable year of inclusion by the foreign corporation shareholder;

c. Distributions by second or third tier foreign corporations with functional currencies other than the U.S. dollar are subject to the following rules:
   (1) If out of post-1986 E&P and included in the gross income of a first or second tier corporation for any taxable year beginning before 1 January 1987, the E&P and foreign taxes shall be translated into dollars under pre-TRA 86 rules;
   (2) If out of E&P accumulated in taxable years beginning before 1 January 1987 by the foreign corporation and included in gross income by a first or second tier corporation for its taxable year beginning after 31 December 1986, the E&P shall be treated as post-1986 undistributed E&P. The foreign taxes paid by the second or third tier corporation shall be translated into U.S. dollars at the distribution spot rate and treated as post-1986 foreign income taxes by the first or second tier foreign corporations.

C. Proposed Regulations dated 26 August 1987

Reg. Sec. 1.904-7 contains transition rules with respect to Sec. 904(d)(2)(i) which largely reflect those contained in Advance Notice 87-6 and in Prop. Reg. Sec. 1.904-9.

D. Final Regulations dated 15 July 1988

Income derived by a foreign corporation in taxable years beginning before 1 January 1987 is initially characterized under pre-TRA 86 rules. When distributed or included under Sec. 951 by the U.S. shareholder, the income is recharacterized under the transition rules of Sec. 904(d)(2)(i).[96]

Where dividends are paid or Sec. 951 inclusions occur before the start of the CFC's first taxable year beginning on or after 1 January 1987 but on or after the start of the U.S. shareholder's first taxable year beginning on or after 1 January 1987, the dividends or inclusions are initially characterized under pre-TRA 86 rules and then recharacterized under the aforementioned transition rules.[97]

X. FOREIGN LOSS RULES

The following rules apply to separate limitation losses after TRA 86.

A. Foreign loss allocation rules (Sec. 904(f)(5)(A))

For foreign tax credit limitation purposes, losses in the separate limitation and the overall basket only offset U.S. source income to the extent aggregate losses exceed aggregate foreign income in other baskets.

1. Where losses are incurred in more than one foreign income basket, each loss is to be allocated proportionally first to foreign income to the extent thereof then to U.S. income.
2. Foreign loss allocation rules are applied on an affiliated group basis and apply to net operating loss (NOL) carryovers.
3. The above foreign loss allocation rule applies before U.S. losses are allocated proportionately to the separate foreign baskets.

B. Separate limitation loss recharacterization rule (Sec. 904(f)(5)(C))

Where loss is allocated from one separate limitation basket or the overall basket (the loss basket) to another basket, subsequent income in the loss basket, to the extent of separate limitation losses not previously recharacterized, will be recharacterized in proportion to the previous loss allocation. The rule applies on an affiliated group basis and to NOL carryovers. Foreign taxes on recharacterized income are not recharacterized and may only be credited against U.S. tax on income in the original basket.

C. Overall foreign loss recapture rule (Sec. 904(f)(1))

The resourcing of foreign source as U.S. source income under the overall foreign loss recapture rule in a year following the overall foreign loss year applies only to the extent that the foreign income is of the same limitation type as the previous loss. Thus the resourcing is limited to the amount of income in the basket in which the overall loss was generated.

D. Disposition of property (Sec. 904(f)(5)(F))

Under the 1988 Act, recognition rules similar to those applicable to overall foreign losses apply to the disposition of property, the gain from which would fall in an

96. Reg. Sec. 1.904-7(a).
97. Reg. Sec. 1.904-7(b)(4).

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income category with respect to which there was a separate limitation loss.

XI. ALTERNATIVE CORPORATE MINIMUM TAX FOREIGN TAX CREDIT (SEC. 59)

TRA 86 replaced the add-on corporate minimum tax with an alternative corporate minimum tax (AMT).

A. AMT

Sec. 55 provides a liability for AMT (with an exception for qualifying income of Sec. 936 corporations) to the extent tentative minimum tax exceeds regular tax for the taxable year.

1. *Tentative minimum tax* (TMT) is 20% (for corporations) of the excess of alternative minimum taxable income (AMTI) over the $ 40,000 exemption amount reduced by the alternative minimum tax foreign tax credit (AMT FTC).

2. AMTI is taxable income adjusted in accordance with Secs. 56 (including the business untaxed reported profits or BURP adjustment) and 58 and increased by Sec. 57 tax preferences.

B. AMT FTC

The AMT FTC is the hypothetical foreign tax credit that would be determined (under Sec. 27) if:

1. U.S. tax in the Sec. 904 limitation formula was the TMT before reduction by AMT FTC;
2. Sec. 904 overall and separate limitation rules were applied to AMTI;
3. Sec. 56(c)(1)(A) BURP adjustment (for 1987-1989 tax years) increase in AMTI is proportionally of the same source and character as pre-BURP adjusted AMTI (and thus will not change the Sec. 904 alternative minimum limitation percentage). For the tax years 1990 and later, the E&P adjustment increase in AMTI will be sourced and characterized on an item by item basis for Sec. 904 alternative minimum limitation.

Excess AMT FTC may be carried forward and back under Sec. 904(c) principles. Regular FTC and AMT FTC carryovers may be different and will have to be tracked separately by taxpayers.

Election to treat foreign taxes as creditable applies for both regular FTC and AMT FTC purposes.

C. 90% Limitation (Sec. 59(a)(2))

No more than 90% of TMT before reduction by AMT FTC may be offset by AMT FTCs even if Sec. 904 limitation calculation permits a greater offset. AMT FTCs disallowed are treated as Sec. 904(c) carryovers. TMT is thus net of both the 90% and Sec. 904 limitations on AMT FTC. Minimum tax NOLs are disregarded (together with AMT FTCs) in applying the 90% limitation to TMT.

D. Transition rules

Pre-effective date regular FTC carryforwards are treated as AMT FTC carryforwards. AMT FTCs are reduced by regular tax FTC carrybacks to pre-effective date years.

E. Sec. 38(c)(3) limitation

The AMT FTC limitation may affect the regular tax liability even where no corporate AMT is payable under Sec. 38(c)(3). The limitation should thus be maximized to the extent possible.

XII. PLANNING AND COMPLIANCE

TRA 86 changes to Sec. 904 substantially increase both record keeping requirements and foreign tax credit limitation computational complexity for tax returns and book provisions. The following represent some of the added record keeping requirements and planning considerations. Given the complexity of the new limitation rules together with the reduction in the U.S. corporate rate to 34%, intuitive analysis of planning suggestions may be misleading unless confirmed by detailed numerical calculations.

A. Record keeping

1. CFC separate and overall basket limitation income needs to be traced and categorized (through tiers of CFCs where appropriate).
2. Look through allocation rules need to be applied to intercompany (CFC) payments of interest, rents, royalties and dividends based on underlying character of income.
3. Foreign subsidiaries accumulated E&P needs to be tracked for purposes of categorization, application of carryforward and carryback rules and new Sec. 902 translation rules.
4. Regular and AMT FTC carryovers will have to be separately identified and tracked.
5. Non-CFC dividends from 1st, 2nd and 3rd tier corporations will have to be separately identified.
6. Booking of undistributed foreign earnings not indefinitely reinvested under APB 23 requires separate basket categorization and, where appropriate, application of the look through rules.

B. Planning

1. Establish an overall plan to minimize excess FTCs for both regular and AMT purposes by identifying and monitoring the limitation baskets into which foreign source income will now fall and, if feasible, restructuring.

2. Identify subsidiaries and debtors in high withholding tax countries (5% or higher withholding tax rate) and attempt to avoid separate limitation actual or imputed interest from these sources.

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3. U.S. parent companies selling stock in a foreign subsidiary could formerly consider having the purchaser make a Sec. 338 election to avoid the non-Sec. 1248 gain being passive income for Sec. 904(d) purposes. TAMRA, however, introduced Sec. 338(h)(16) which appears to negate this planning opportunity for qualified stock purchases made after 10 June 1987.

4. Monitor distributions out of PTI from CFCs in foreign countries that either impose a withholding tax or reduce the underlying corporate rate of tax on undistributed earnings. Consider distributions in the prefiling period where appropriate.

5. Plan to utilize excess FTC, by considering having fewer Sec. 863(b) sales through FSC thereby increasing foreign source income for limitation calculation. Benefit of increased credit utilization needs to be compared with cost of FSC benefit foregone and the nonapplicability of Announcement 89-11 to those sales.

6. Plan for AMT on future distributions of exempt dividends by tracking FTC carryforwards for AMT purposes and by attempting to maximize use of minimum tax credit.

XIII. 1988 ACT CHANGES TO FOREIGN TAX CREDIT PROVISIONS

A. Amendment to Sec. 901(j)

Effective 1 January 1987, income of any domestic corporation receiving dividends or income inclusions from a foreign corporation is not grossed up by foreign taxes the latter pays that are not creditable under Sec. 901, regardless of whether the domestic corporation otherwise chooses the benefit of the foreign tax credit. This will apply to dividends from South African subsidiaries.

B. Amendment to Sec. 904(b)(2) and (3)(D)(E)

In conformity with the repeal of the alternative tax rate on capital gains for corporations, this Section was amended to provide that taxable income from sources outside the United States will include gain from the sale or exchange of capital assets only to the extent of foreign source capital gain net income. If there is a capital gains rate differential, then foreign source income will equal the foreign source gain reduced by the rate differential portion of the foreign source net capital gain.

New definitions of capital gain rate differential and rate differential portion have been added to this Section.

C. Addition of Sec. 904(d)(2)(A)(iv)

This new provision clarifies that in determining whether income would be foreign personal holding company income, the related person factoring rules under Sec. 864(d)(6) will only apply in the case of an actual CFC. Thus, income earned directly by a U.S. person may be eligible for the export financing exceptions under Sec. 904(d)(2).

D. Amendment to Sec. 904(d)(2)(B)(iii)

This Section clarifies that a tax collected by a foreign taxing authority using a withholding type mechanism does not necessarily classify such tax as a gross-basis tax and thus make the interest income subject to the high-withholding tax interest exception under Sec. 904(d)(2)(B).

E. Amendment to Sec. 904(d)(2)(C)

This Section is clarified to provide that only income of persons *predominantly engaged* in the active conduct of a banking, insurance, or financing business is separated into the financial services income basket.

F. Amendment to Sec. 904(d)(2)(D)

Dividends from a non-controlled Sec. 902 corporation that might otherwise constitute shipping income are to be placed in that corporation's dividend basket. Separate basket treatment of dividends is required for dividends paid by a CFC out of its shipping income when the taxpayer has established that the income was taxed by a foreign government at more than 90% of the maximum U.S. rate. Thus taxpayers may cross credit taxes on any highly taxed shipping income against the U.S. tax on other shipping income they may earn.

G. Amendment to Sec. 904(d)(3)(E)

The effect of the provision that treats income meeting the de minimis rule under Sec. 954(b)(3)(A) as nonseparate income is limited by the Act. De minimis treatment applies only to a CFC's foreign base company sales income and gross insurance income for the tax.

H. Amendment to Sec. 904(d)(3)(F)

The exception that passive income does not include any high-taxed income does not apply in determining whether any income of a CFC is in a separate category. The determination of whether any amount of income is treated as high taxed income will be made after the application of the look through rules of CFCs.

I. Addition of Sec. 904(d)(3)(H)

The Act clarifies that income of a U.S. shareholder allocable to separate category income of a CFC will retain the character in the hands of the U.S. shareholder, subject to the high tax kick-out. Thus, interest that technically may qualify as export financing interest paid by a CFC to a U.S. shareholder out of the corporation's passive basket will be in the shareholder's passive basket rather than the overall basket.

J. Addition of Sec. 904(d)(3)(I)

Any amount of income included in gross income of a U.S. shareholder under Sec. 1293 shall be treated as income in a separate category to the extent it is attributable to such category.

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K. Addition of Sec. 904(f)(5)(F)

This Section provides that recognition rules similar to those applicable to overall foreign losses apply to any disposition of property, the gain from which would be in an income category whose separate loss was allocated against separate limitation income.

L. Amendment of Sec. 904(g)(10)(11)

This Section provides new treatment for any amount derived from a 50% U.S. owned foreign corporation that the statute would treat as U.S. source income, but that the taxpayer, pursuant to any U.S. treaty, treats as foreign source income. To the extent attributable to an item of U.S. source income earned by the foreign corporation, the taxpayer's inclusion is treated as foreign source income subject to a separate foreign tax credit limitation.

M. Addition of Sec. 964(d)

A new election is provided under which an "insurance" branch of a CFC can be treated as a separate foreign corporation, considered to be created under the laws of the country in which it conducts its operations, if the branch meets the definition of a "qualified insurance branch".

XIV. 19 JANUARY 1989 TEMPORARY REGULATIONS REGARDING FOGEI AND FORI

On 19 January 1989, Temporary Regulations were issued under Sec. 907 regarding the limitation on the foreign tax credit for foreign oil and gas taxes. The Regulations give effect to certain Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amendments regarding the aggregation of foreign oil and gas extraction income (FOGEI) and foreign oil extraction losses from all foreign countries prior to the computation of the limitation of Sec. 907(a) and (c)(4).

Non-dual capacity taxpayers and dual capacity taxpayers that use the facts and circumstances method of Reg. Sec. 1.901-2A(c)(2) to determine creditable taxes must apply the safe harbor formula of Reg. Sec. 1.901-2A(e)(1) to foreign oil related income (FORI) tax payments to determine the amount of FORI tax that is creditable under Sec. 907(b).

Conference Diary

OCTOBER 1989

Technology Transfer to China. Lucerne, 12-13 October (English):
Zentrum für Unternehmungsführung AG, Schulstrasse 7, CH-8802 Kirchberg-Zürich, Switzerland.

International Tax Compliance and Enforcement. London, 18 October (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

Fiscale Beslissingen bij Beheer en Transacties van Onroerend Goed. Amsterdam, 19 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

The European Finance Symposium, including the World ECU Symposium. Antwerp, 24-28 October (English):
Europa S.A., avenue Jules César 14, 1150 Brussels, Belgium.

Doing Business between the European Community and the Comecon (CMEA) Countries. Budapest, 26-27 October (English):
Seminar Services S.A., 12, avenue de Beauregard, CH-1701 Fribourg, Switzerland.

Trusts and the EEC – International Tax Planning for the Protection of Wealth. Geneva, 25-26 October (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

Leasing Law in the E.E.C. Brussels, 26-27 October (English):
Ms. Caroline Carter, Asset Finance Seminars, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom.

IBFD-MIEM (Bocconi University) Seminar on Corporate Tax Strategy in Europe and the United States and Intercompany Pricing. Milan, 26-27 October (English):
International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands.

NOVEMBER 1989

Unit Trust Management – a 2 Day Conference for Junior Managers. London, 2-3 November (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

Leasing; Innovative Financing; Tax Advantages. Brussels, 6-9 November (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

Fiscale Harmonisatie en de Gevolgen daarvan voor Nederland. Rotterdam, 7 November (Dutch):
Nederlands Studie Centrum, Antwoordnummer 350, 3130 VB Vlaardingen, The Netherlands.

Taxation of Unit Trusts – The New Rules. London, 7 November (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

1993 and its Consequences for the EFTA & the CMEA (COMECON) Countries. Budapest, 6-8 November (English):
PW Business Conferences, Hoeschgasse 78, CH-8034 Zürich – Switzerland.

How to Set-Up and Operate Holding and Finance Companies. Paris, 9-10 November (English):
Seminar Services S.A., 12, avenue de Beauregard, CH-1701 Fribourg, Switzerland.

The 12th Annual Congress of the American Tax Institute in Europe: New Developments in U.S.-European Taxation. Cannes, 13-15 November (English):
The American Tax Institute in Europe, 9, Avenue Matignon, 75008 Paris, France.

I.T.P.A. Seminar. Palm Beach, 20-21 November (English):
Ms. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 65Z, United Kingdom.

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

APTIRC-IBFD International Tax Seminar: Europe 1992 – How Does It Affect Taxation and Investment in the Asian-Pacific Region? Singapore, 27-28 November (English):
Asian-Pacific Tax and Investment Research Centre, 2 Nassim Road, Singapore 1025.

DECEMBER 1989

Fundamental Elements of U.S. Federal Taxation. U.S. / International Taxation: Tax Strategies for Cross Border Activities; U.S. Taxation: Oil and Gas – Including International Aspects. United Kingdom, 4-9 December (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, U.K. Telephone (1) 935 7502, telefax (1) 935 1308.

Taxation of Branches and Subsidiaries. Brussels, 7-8 December (English)
Management Centre Europe, rue Caroly 15, B-1040 Brussels (Belgium).

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Budgetary Theory and Policy in a Small Developing Country:

The Case of Barbados 1960-1988

Andrew S. Downes

This paper was prepared for presentation at a Symposium on: ISSUES, PROBLEMS AND PROSPECTS IN PUBLIC FISCAL AND FINANCIAL PROPOSALS IN BARBADOS AND THE ORGANISATION OF EASTERN CARIBBEAN STATES sponsored by the Friedrich Ebert Stiftung Foundation and the Department of Government and Sociology, UWI, Cave Hill Campus on Saturday, 5 November 1988.

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I. INTRODUCTION

A study of the political economy of Government budgeting necessitates an examination of the fundamental principles governing the allocation of public resources among alternative ends at various stages of the historical development of the economy. The increasing demand for socio-economic development in small, developing countries has meant an increasing role for the public sector in the economic activity of these countries. The Government through its many instruments is required to regulate and control economic activity, provide public or social goods, stabilize the course of business activity, redistribute income and wealth and effect the economic transformation of the country. These tasks have become the major objectives of the Government's budgetary policy formulation. The economic, social and political constraints of an existing period, however, determine the extent to which the Government can adequately carry out these responsibilities. Nevertheless, its social responsibility is such that it seeks to achieve as many of these objectives as possible in order to satisfy its constituents.

The main purpose of this article is to analyze the macro-economic aspects of budgetary policy in Barbados during the period 1960-1988. The analysis focuses on the social, developmental and stabilization aspects of Government budgeting during various stages of the development of the Barbados economy. Three phases of Government budgeting are examined: the pre-independence period, 1960-1966, the early post-independence years prior to the so-called 'energy (oil) crisis' in 1973 and the post-1973 period. The basic rationale behind such a division derives from the theory that budgetary policy reacts to and influences political and economic phenomena in both the domestic and international arenas. The pre-independence period was marked by 'colonial budgetary procedures' derived from the policies of the U.K. Colonial Office to provide the perceived 'basic necessities' of the country within the context of a 'balanced Budget'. The granting of independence in 1966 saw an attempt by the Government to break away from the rigidity of 'balanced budgeting' and to adopt a developmental approach to budgeting in terms of deficit financing. The escalation of petroleum and raw material prices since 1972 has significantly influenced the nature and scope of Government budgeting. Stabilization policies to lessen the impact of inflation and to avoid balance of payments (BOP) and fiscal deficits have become the central focus of budgeting policy since 1973. At the same time the Government has sought to implement programmes and provide fiscal assistance to businesses in order to increase domestic production and employment and to improve social welfare and the distribution of income.

The structure of the analysis is as follows: first, an outline of the nature of Government budgeting is presented. Second, the budgeting framework within which Government financial management is undertaken is briefly examined. Third, the nature of budgetary policy in Barbados over the 3 periods is discussed. Finally, an evaluation of Government budgetary theory and policy in the context of a small, developing economy is undertaken.

II. THE NATURE OF GOVERNMENT BUDGETING

A Budget is a comprehensive financial plan of the Government with regard to its expenditure and revenue raising actions. It is an attempt to use available resources to implement various political decisions.

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The budgetary process involves the formulation or preparation of outlays and receipts by the Government (through departments and Ministries) for the fiscal year, the review and authorization of the plan by the legislature, the implementation of the plan (i.e. the process of disbursing funds and the institution of fiscal policies), and finally the evaluation and public reporting of the plan.

The purposes of Government budgeting are fourfold (see Goode, 1984, at 9). First, budgeting sets out the framework for policy formation whereby decisions are taken about ways to attain certain objectives. For example, the Government may need to grant fiscal incentives to companies to promote private sector development. The extent and nature of these incentives depends on the current state of Government finances and the long-term impact of the incentives on Government revenue. Second, budgeting provides a means for policy implementation which can act as a guide to public sector management. Third, budgeting provides a means of legal control by the legislature to prevent overt abuse of power; the Government is accountable to the public for the use of public resources. Finally, in producing a set of public documents (Estimates of Expenditure and Revenue and the Financial Statement and Budgetary Proposals), the Government can indicate its past activities, current and future actions with a view to fashioning the economic expectations and behaviour of non-governmental units.

Government budgeting affects general economic activity in terms of the utilization of resources, that is, the division between current consumption and investment (future consumption) in the promotion of economic growth and development, the maintenance of macro-economic 'balance' or equilibrium in terms of price stability, lower unemployment, reduced BOP deficits, the social division of income and wealth (i.e. the redistributional effects of Government expenditure and tax measures) and the degree of state or public economic activity vis-à-vis private sector activity. One of the main reasons for Government expenditure is the provision of 'public goods and services' such as defence, education, transport and legal services. These activities impact upon both current and capital Government expenditure.

Financing Government expenditure is undertaken through 4 sources. Probably the main source of funds is taxation. The extraction of resources from individuals and firms is undertaken both directly and indirectly (e.g. income taxes, consumption taxes, import duties, etc.). A second source of revenue is the public sector provision of services such as postal, waterworks, etc. Borrowing from both domestic and foreign institutions provides a third source of funds. The Government can borrow domestically from commercial banks, insurance companies and other financial intermediaries. Foreign governments, the International Monetary Fund (IMF) and other international financial institutions also provide sources of foreign funds. The final source of Government revenue is money creation or borrowing from the Central Bank.

The basic features of a country usually dictate the nature of public budgeting. In the case of a small, developing country, it is expected that public budgeting would be developmental in nature with annual budgeting integrated with medium-term development planning. In some cases, the existing economic conditions may necessitate policies to stabilize the economy. But in the case of a small developing country, the stabilizing exercise should not detract from the general developmental thrust of public budgeting.

A 'small, developing country' is characterized by a 'small' land area, 'small' population, relatively low level of per capita income, a high incidence of foreign trade, a 'small' domestic market, a general inability to influence both export and import prices by varying the supply of and demand for goods, a relatively low rate of domestic savings occasioned by the low per capita income and by a skewed distribution of income and endogeneity of the money stock. These features condition the nature of public budgeting in so far as they dictate the sources of revenue and the targets of Government expenditure. For example, a 'small' land area is usually associated with a low level of diversity of natural or land-based resources. In some cases, a single major resource may exist which dominates both Government revenue and expenditure. Furthermore, the high incidence of foreign trade and the relatively low level of per capita income determine the distribution of tax revenue and the elasticity of the tax system. In analyzing the nature of public budgeting with respect to its stabilization, developmental and social effects, both the characteristics of the country and the existing economic conditions should be taken into account. In this case study of Barbados during the period 1960-1988, the basic features of the economy are taken into account in analyzing the effects of Government budgeting.

III. BUDGETARY FRAMEWORK IN BARBADOS

The successful implementation and administration of budgetary measures necessitates a system or framework which is efficient and responsive to structural change. A budgetary system can be conceptualized as a matrix of organized procedures which are established by institutions and individuals to facilitate the expenditure and revenue-raising process. It consists of units each having clearly demarcated lines of duty. However, the close interaction of the units is necessary for minimizing both administrative and informational costs. The flow of information between these administrative units determines the extent to which the overall budgetary system is efficient and budgetary procedures are logically consistent.

A budgetary system in terms of its administrative and legislative functions provides for procedures requiring the Government to obtain final approval for undertaking expenditure and revenue-raising policies, the formulation of budgetary policy measures, the ability of the system of budgeting accounts to convey information relating to the effects of various policy measures

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and a system of budgetary control as it relates to streamlining expenditure and maximizing revenue collection.

The primary responsibility for public budgeting in Barbados, like that in other parliamentary democracies, lies with the Executive. The members of the Executive may either be elected or nominated to form the Cabinet. The administrative structure of Government consists of a number of departments or ministries which are classified according to functional heads: defence and security, agriculture, health, etc. Each department or ministry who sits in the Cabinet is responsible for the budgetary process within that department.

The Ministry of Finance and Planning (Economic Affairs) is regarded as the coordinating agency with respect to the budgetary submissions of other departments. The Finance Division of this Ministry is responsible for budgeting, accounting and auditing. After the budgetary proposals are prepared by the Finance Division they are discussed by the Cabinet. The announced budgetary proposals of the Government are generally preceded by 2 documents which assist the Executive and Legislature (Parliament) in the budgetary control process. These documents are the 'Barbados Estimates', i.e. the annual (fiscal year) estimates of expenditure and revenue as required under the Appropriations Bill and the 'Economic Report (Survey)' which reviews the performance of the economy during the previous calendar year. The Financial Statement and Budgetary Proposals of the Government, which will be the focus of this study, consist of measures for raising revenue and stimulating economic activity.

The system of public financial administration is governed by the Financial Administration and Audit Act of 1964. The Act stipulates that revenues such as levies, taxes, rates, etc. be paid into the Consolidation Fund; the public debt, including the interest on debt, sinking fund payment and redemption money with regards to debts and costs, charges and expenses incidental to the management of the public affairs be charged to the Consolidation Fund; and the disposal of funds for meeting the costs of public services be undertaken in accordance with the stipulations in the Appropriations Act. The Act also provides for the control, management and audit of public finances, the regulation of receipts and the control and issue of public funds.

The framework within which budgeting operates in Barbados can be termed 'traditional' (see United Nations, 1986). Traditional budgeting serves the purpose of legislative authorization and control. The major divisions are a series of 'votes' by which money is appropriated to ministries. The minor divisions of traditional budgeting are objects of expenditure, i.e. the items on which money is spent. Only the goods and services needed by ministries and the revenues expected in a forthcoming year are specified in the traditional Budget. Little or no information is provided on programmes and their purposes, cost and output. The 'traditional' Budget serves a narrow range of users. This type of budgeting can be compared with performance budgeting, zero-base budgeting and planning- programming-budgeting systems (PPBS) (see United Nations, 1986).

IV. BUDGETARY POLICY IN BARBADOS

Odle (1978) has identified 3 stages through which budgetary policy in the Caribbean has evolved: traditional, transitional and transforming. The traditional phase represents the feudal relationships in Caribbean society up to the period of emancipation, 1938. This period was marked by agro-based production (plantation agriculture) with political power concentrated in the hands of landowners. The main revenue source was import duties, while public expenditure was directed towards the efficient operation of the plantations and the maintenance of law and order.

Within the transitional phase, Odle demarcates 2 subphases: a breakaway period extending from 1838 to the late 1920s and an adoption-of-modernity period covering the early 1930s to the 1960s. During the transitional phase indirect taxation systems were further developed and modern forms of direct taxation introduced. Tax concessions were granted to encourage both domestic and foreign investment.

The transforming stage is largely a post-independence phase whereby the Government sought to transform the productive structure of the economy by both taxation and expenditure measures.

The broad periodizations suggested by Odle provides a historical framework within which budgetary policy can be examined in the Caribbean. The main budgetary measures of each period indicate the central focus of Government policy. In the case of Barbados, the 3 periods identified in this study fall within the transitional and transforming phases, i.e. the pre-independence period (pre-1966), the early post-independence period (1967-1972) and the post-'oil crisis' period (1973-1988).

A. Pre-independence period: 1960-1966

When internal self-government was granted in the early 1960s (1961), much of the responsibility for the public affairs of Barbados rested with the domestic Government although the Colonial Office still oversaw some of the public operations. One of the major constraints on the nature of the Government's budgetary policy was the existing dependence on colonial monetary arrangements. Under this system, there were severe limitations on the extent to which the colonial Government could run a current account deficit. The Government had no control over the money supply or commercial bank credit. This lack of monetary control meant that the Government's power to pursue deficit financing was limited by the foreign reserves at its disposal (Howard, 1979). Both the monetary and fiscal dependence lessened the extent to which the Government could have structurally transformed the economy. Nevertheless, the Government still maintained that its responsibility was the provision

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of the pre-conditions for economic development. Given its limited manoeuvrability, the Government set about its task of national development through a series of medium-term plans and annual public budgets.

Development 'plans' were formulated primarily to satisfy the criteria of foreign financial institutions. These 'plans' produced a series of social and economic programmes guided by a strategy of gradualist development and these 'plans' were complemented by an annual public Budget which reflected much shorter policy objectives. Budgetary policy, however, had an impact on the achievement of long-term development objectives.

1. Development policy

One of the central aims of budgetary policy during the pre-independence colonial period (1960-1966) was the provision of the infrastructural facilities and other preconditions for a 'take-off' from a period of stagnation. This aim was reflected in the pattern of Government expenditure which indicated an emphasis on economic services, especially road and transport systems, in both the recurrent and capital Budget accounts. During the period 1960-1966, economic services accounted for 25% of current expenditure and between 60-90% of the capital expenditure Budget.

Budgetary policy was also influenced by the nature of the Government's development policy. In the late 1950s, the Government embarked upon an industrialization programme through a series of fiscal incentives (see Cox, 1982; Howard, 1986; Downes, 1985a). Industrial development was seen as the panacea for the problem of unemployment. Official unemployment statistics indicated that in 1960 the rate was 7.8% and in 1965 it was 13%. These data, however, underestimate the level of un- and under-employment in the economy. Emigration to the United Kingdom, the United States and Canada was actively encouraged by the Government in an effort to relieve some of the pressure on the domestic labour market. The rationalization of production resulted in a release of labour from the agricultural sector; hence, reliance had to be placed on other sectors, namely, manufacturing and tourism.

In order to hasten the pace of industrial development, the Government relied on foreign investment. Industrial estates and other social services (roads, waterworks, transport facilities – airport and harbour) were established. This outlay in Government capital expenditure was seen as the 'cost' of achieving long-term economic development. The Government also sought to encourage tourism by adding to hotel accommodations and improving and enlarging the airport facilities. With the gradual decline of the agricultural sector as a major employment generator, manufacturing and tourism became the main areas of attention for development planning and budgetary policy. Indeed, the major theme of the 1965 Budgetary Proposals was the encouragement of the manufacturing sector in an effort to relieve the problem of high unemployment.

The changes in the tax structure can be seen as having a dual role: stimulating industrial production and raising revenue to meet the relatively high level of Government expenditure. Minor adjustments were made to the income (personal and corporate) tax structure although the Government saw the need for major income tax reform to encourage local industry and increase the pool of skilled workers. Import duties were increased on such items as paints, enamels, wooden and upholstered furniture and garments. The 'easy' phase of import substitution industrialization (i.e. the domestic production of previously imported consumer goods) was enhanced by tax measures (abolition of import duties) which sought to reduce the costs of imported raw materials used in the garment factories and small craft shops. The adjustments in the tariff structure increased the degree of 'effective' protection of these 'early industries' and resulted in an estimated net loss in revenue of East Caribbean (EC) $ 163,000 in 1965. The Government, however, expected that the output and employment effects of its commercial policies would outweigh the revenue loss incurred. With the increase in employment, the Government would be able to increase its collection of income taxes.

While the domestic savings constraint in such a low income economy encouraged the Government to institute a range of fiscal concessions to industry, the foreign exchange constraint was still a major concern to the Government. Income tax concessions were granted to enclave enterprises while the passing of the Export Industries Act in 1969 further provided for the expansion of exports and employment. The investment allowances granted to both local and foreign enterprises were increased by 20% so that they could recover from taxable profit a further amount of the cost of any plant and machinery.

By 1965, modest success was achieved through the institution of fiscal incentives. Out of the 8000 persons employed in the manufacturing sector it was estimated that 2,156 persons (27%) were employed in 41 pioneer enterprises. As Odle (1977) has pointed out "although the basic tax structure is a legacy of the exploitative colonial period, the regimes since internal self-rule and subsequent political independence have compounded the matter by introducing new fiscal measures which have led to the rise in a new manufacturing class, dominated by foreign capital (or indirectly by foreign technology) and repressive of labour and the working class; and that local capital is playing a complementary role" (p. 396). The budgetary system and measures only intensified the degree of functional dependence in the economy of Barbados.

2. Stabilization policy

Budgetary policy, in addition to its developmental role, should be designed and tailored to provide solutions to short-run problems confronting the economy. During the colonial period, Barbados could be classified as a dependent or externally propelled economy. The basic features of such an economy are given by Thomas (1965):

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> the degree to which the economy is resilient to changes taking place in the rest of the world and this would depend upon, among other factors, (a) the level and rate at which domestic real per capita incomes are increasing over a relevant period of time and (b) the extent of unemployment of existing resources

and:

> the degree to which the economy depends on the rest of the world to maintain and increase internal levels of employment, output, demand and prices (p. 3).

The conditions describing a dependent economy determine the extent to which a Government can undertake various stabilization policies. Low and erratic output growth, high rates of unemployment and a situation in which key variables in the economy are externally determined lessen the extent to which a colonial Government could have undertaken stabilization policies as conventionally understood. In many respects, accommodating actions would more appropriately describe the behaviour of the Government's short-term policy actions. Reliance on automatic or built-in stabilizers would be more important in such circumstances since the discretionary element in budgetary policy tends to be limited in colonial financial systems. In addition to the institutional constraints on discretionary budgetary policy, the Government needed to be mindful of fiscal drag, in that the automatic stabilizers act as a brake or reduce the effectiveness of any discretionary policies.

The export-led growth strategy based on mono-culture agriculture meant that changes in sugar production and exports affected the growth path of the overall economy. The high level of sugar production in 1963 (194,000 tons) and the corresponding high sugar price (Bds$ 242 per ton) resulted in an overall growth rate of 12.6% in 1963. The increase in sugar prices was due to poor crops in the main sugar producing countries and the "Cuban Crisis". The erratic nature of the growth path of output was clearly evident in 1964 when both sugar output and prices declined to 165,000 tons and Bds$ 218 per ton, respectively (that is, a fall in output by 2.6%). The fluctuating fortunes of the sugar industry was one of the main factors which led the Government to stimulate activity in the manufacturing and tourism sectors.

Inflation, although very modest, was attributed to increases in import prices and interest rates. The recurrent pressure on sterling led the Bank of England to adopt a restrictive monetary policy which increased the rates of interest within the sterling area. In addition to affecting the inflation rate, high interest rates abroad greatly affected Government borrowing for capital expenditure. Government policy towards inflation was largely accommodating since the openness and institutional dependence of the economy meant that the Government could not have affected the rate of inflation (see Downes, 1985b).

Due to the absence of a Central Bank, the "budgetary management (of government) was constrained by the view that current revenue should balance current expenditure" (Howard, 1979, p. 51). The principal means of balancing the Budget in the pre-independence period was taxation. In the early 1960s, consumption taxes were imposed on a range of goods (aerated and mineral water, cigarettes, gasoline), customs tariffs were increased and the rice subsidy paid to Guyanese rice producers was reduced. The increase in Government expenditure, however, forced the Government to adopt a deliberate policy of budgeting for a deficit by the mid-1960s. Public capital investment was financed by external loans. In a period of high unemployment deficit, budgeting was expected to stimulate the economy by increasing aggregate demand, employment and income. There is a feedback to Government revenue via the direct and indirect tax mechanism. In an open economy such as Barbados, leakage from the income stream in the form of imports reduces the multiplier effect of an increase in Government expenditure.

The openness of the Barbados' economy means that the balance of payments should be the target of budgetary policy. The promotion of industrial development and tourism brought a widening of the visible trade gap due to the increase in demand for intermediate, capital and consumer goods. The Government expressed a need to increase local production (import substitution) and exports in order to increase the import capacity of the country. However, increasing protectionism in the international economy, fluctuations in the commodity terms of trade and inadequate incentives to non-sugar agriculture imposed further constraints on the ability of the Government to reduce the visible trade gap. Although there is some dispute as to whether or not a balance of payments problem can exist in a dependent monetary system (see Thomas, 1963, at 97-103), a BOP problem shows itself in high levels of unemployment, increasing imports and a slow rate of output growth.

Government budgeting should be an instrument for combating unemployment, income inequality and slow economic growth. The dependent nature of the economy, however, limited the scope of conventional stabilization policy. The Government's reaction was largely accommodating as it was concerned with the increasing public debt incurred to finance development projects, the large adverse balance of trade position and the high cost of borrowing in the international capital market. Little emphasis was placed on functional finance, that is, the realization of a deficit or surplus in order to achieve clearly specified objectives. The main concern was with the rigidity of balancing the Budget.

3. Social policy

The social aspect of Government budgeting in the colonial period was grossly neglected. Although education accounted for a significant proportion of the public Budget, health, social security and welfare services were largely underdeveloped. Pensions were very small, Bds$ 10 per month in 1963. In 1966, Government pensioners, numbering over 1,700, were paid Bds$ 2.5 million in benefits. The lack of an adequate

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social security scheme was compensated by a widow-orphan fund set up for public servants. The Government had promised the development of a comprehensive social security system for the country in the post-independence era. Funds obtained from the Colonial Development and Welfare Programme were used to develop health facilities by way of the Queen Elizabeth Hospital. The school meals service which was started in the early 1960s on a pilot basis was further extended in the mid-1960s.

The thrust of Government's budgetary policy in the pre-independence colonial period was towards establishment of the pre-conditions for industrial development. The fluctuating fortunes of the sugar industry hastened the process in the mid-1960s. Import substitution (light) manufacturing was the main foundation on which employment generation and output growth were to take place. Although there was some relief in the labour market in terms of emigration, un- and under-employment still remained a pressing socio-economic problem. The increasing level of Government expenditure and the granting of fiscal incentives meant that the Government had to resort to foreign borrowing and deficit in the mid-1960s. The use of conventional stabilization policies was limited by the dependent nature of the financial system and accommodation was the main approach adopted by the Government when faced with short-term macro-economic problems. Social aspects of budgetary policy were neglected as scarce financial resources imposed a trade-off on the Government in terms of economic versus social policy. The emphasis on economic development can be seen as a means by which resources would emerge in the long run to provide for social development.

B. The post-independence period 1967-1972

The granting of constitutional (political) independence in November 1966 was expected to be followed by policy actions to reduce the level of functional economic dependence. The Government was not given full autonomy to manage its own financial affairs. Budgetary policy was now expected to provide the basis for the economic transformation and social development of the country. The reduction of functional economic dependence would mean that greater use had to be made of stabilization policies in periods of stagnant economic activity and creative development policies.

C. Development policy

The budgetary policy of the Government continued to be focused on infrastructural development. The Government borrowed externally in order to undertake such capital works projects as the harbour extension, airport improvement and the construction of new schools. Although these projects were not designed to be directly income-generating, their ability to facilitate industrial and tourism activity provided Government with an indirect source of revenue. These long-lasting projects were seen as creating inter-generational benefits and their financing would be undertaken by current and future generations. The need for Government borrowing stemmed from a situation where the 'ability to accumulate capital is concentrated in the hands of a few who do not necessarily nourish a propensity to invest their saving in the land of their birth'. While the expansion of the public debt can be justified in terms of the ability of the Government to provide employment for unskilled and semi-skilled labour, there are limits on the size of the public debt since the country's ability to service and repay the debt depends on its export capacity.

The Government continued its effort to stimulate industrial investment. The provision in the Income Tax Act which prohibited a deduction of interest unless the recipient was exempted from the tax (or that tax which is chargeable on the interest) was removed. Allowances were granted for Research and Development (R&D) expenditure in certain industrial operations. These allowances permitted appropriate expenditures on plant and equipment to be written off over a period of 5 years. In addition, buildings used for scientific research qualified for an industrial building allowance. In order to afford local shirts, hats and toothpaste producers greater protection, the customs duties were raised. The degree of protection afforded to beer producers was increased through the removal of the duties on imported raw materials.

The Caribbean Free Trade Agreement (CARIFTA), signed in 1968, was seen as another avenue through which the Government could increase industrial exports. CARIFTA provided a wider regional market for both agricultural and industrial goods thus allowing plants to reap economies of scale. The removal of import duties on a wide range of regionally produced goods meant that some Governments suffered a substantial revenue loss (i.e. the CARIFTA effect). In order to counterbalance this revenue loss, consumption taxes were raised along with import duties on a range of 'luxury' goods imported from extra-regional sources. In addition to meeting the shortfall in revenue, the imposition of these taxes was designed to foster local production by means of import substitution. The immediate increase in consumption taxes and import duties suggest that the production, income, employment and revenue effects of free trade were slow to emerge.

In 1967, the British pound was devalued. This effectively devalued the Eastern Caribbean dollar which was freely convertible into the pound sterling under a system of 100% reserve holding. This devaluation aided the tourist industry in that it was cheaper for the British tourist to visit the Caribbean. It was estimated that 30% of the Government's current revenue was derived from the multiplier effect of tourist expenditure. The tourist sector was, however, unable to forge strong linkage with other sectors of the economy. The increase in tourist arrivals and expenditure occasioned by the devaluation increased the importation of foodstuffs rather than the expansion of non-sugar agriculture. Armstrong et al. (1974) estimated that "on

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the average, a dollar's worth of tourist spending generated directly and indirectly one dollar and forty one cents of output over all industrial sectors taken together. Fifty per cent of the total supply of output generated was provided by the 'hotels' industrial sector while about one third of the total supply was provided by the other key industrial sectors ...." (p. 517). There were little or no incentives in Government's budgetary policy to encourage greater inter-sectoral linkages.

Over the period 1967 to 1972, there was a general decline in the output of sugar. Output declined from 204,000 tons in 1967 to 113,000 tons in 1972 (a decline of 45%). There was, however, a general increase in the export price of sugar. In 1967, the export price of sugar was Bds$ 199 per ton, while in 1972 it had risen to Bds$ 289 per ton. The sugar industry was faced with serious technological problems which needed a reorganization and diversification programme. Budgetary policy was aimed at initiating technical improvements in the industry. The thrust towards mechanization was encouraged through the increase in the investment allowance for agricultural and sugar machinery from 20% to 40%.

Government's financing of the capital Budget was mainly through loans, temporary borrowings (i.e. the issue of Treasury bills) and surpluses realized on the current account. The constraint on the availability of financial resources was due to the inability of the Government to effectively operate with the existing financial machinery which was still based on colonial monetary arrangements. Between 1960 and 1970, total capital expenditure was Bds$ 95.5 million of which Government surpluses accounted for Bds$ 29 million (i.e. 31%). The financing of capital development was supplemented by a deliberate policy to encourage the inflow of foreign capital to assist in the development of the industrial and tourism sectors.

The Government's budgetary policy with respect to economic development in the early post-independence era was guided by the principles of maximum mobilization of local resources, an equitable distribution of the tax burden and the stimulation of investment in productive areas of the economy. With a binding foreign exchange constraint, the thrust was towards import substitution and export promotion. The Government tried to relieve the income tax burden by increasing allowances and rescheduling the rates of taxation. These budgetary measures were aimed primarily at increasing disposable income and/or domestic savings. Although the increase in disposable income resulted in an increase in imports, there was also an increase in the demand for locally produced goods. The mobilization of domestic resources was further enhanced by the issue of tax-free development bonds and Government debentures.

1. Stabilization policy

The budgetary policy of a Government is informed by past, current and prospective trends in the economy. The degree to which specific tax policies can be followed depends on the level of per capita income and the administrative capacity to collect taxes and other fees. The growth of Government expenditure is crucial in determining the economic growth performance in a situation in which private investment and exports are subject to a high degree of uncertainty. In a small, open economy such as Barbados, excess aggregate demand affects the BOP more than the rate of inflation; hence the nature of demand management policies differ from those in more developed economies (see Downes, 1982). In many respects, the Government's approach to inflation and BOP problems was accommodating rather than autonomous.

The devaluation in November 1967 resulted in an increase in the rate of inflation. In 1966, the rate of inflation was 3.2% while in 1968 it was 9.3%. In addition, interest rates in international capital markets began to increase, thus further fueling the domestic rate of inflation. Given the externally induced nature of inflation, policies were adopted to adjust to the inflationary situation. Price controls were instituted on a range of consumer goods in an effort to dampen the effects of inflation on the standard of living. Tax measures were designed to cushion the adverse inflationary effect of devaluation and to discourage the import of luxury and locally substitutable consumer goods. The Government was, however, caught in a dilemma. Import duties were increased on a number of "luxury" items while consumption taxes were instituted to recover the revenue loss effect of CARIFTA. These measures further increased the general level of prices in the economy. Price controls on a number of basic goods were continued beyond the scheduled period, that is, a case of "suppressed" inflation. In 1970, the Government proposed the establishment of a Prices Commission designed to protect consumers against excessive price increases in the distribution sector. Given the average cost pricing practices of the distribution sector, price controls would moderate the extent to which traders and importers could have increased profit margins. The wide application of price controls may have resulted in "side-market" activity and commodity shortage which would affect the welfare of consumers as any 'consumer surplus' was transferred to traders and importers.

The main revenue source continued to be indirect taxation, i.e. customs duties and consumption taxes. These taxation measures were directed towards "luxury" items and commodities which were largely price inelastic – cigarettes, some alcoholic beverages. In addition, high rates on extra-regional goods were intended to promote inter-regional trade. Indeed, the 1972 Budget was explicitly designed to "set the region on the road towards a Caribbean Common Market" with a common external tariff.

An important feature of the early post-independence period was the use of the policy of deficit financing, i.e. a situation where planned expenditure was larger than planned tax revenue. This policy orientation was influenced by Keynesian macro-economic thinking which suggested that increases in aggregate demand

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(through an increase in Government expenditure) would stimulate the economy. As indicated earlier, too rapid a growth in Government expenditure (i.e. aggregate demand) has serious BOP effects in a small, open economy. Indeed, the deficit balance on current account increased from Bds$ 30 million in 1967 to Bds$ 83 million in 1972 and Bds$ 102.4 million in 1973.

The early post-independence period (1966-1972) was generally one of high output growth. All the sectors of the economy with the exception of agriculture recorded growth rates above 6% per annum. Such high rates of output growth may be partly due to the principle of deficit budgeting which was adopted to "avoid a deflationary situation and to encourage consumer demand" for local goods. Moreover, changes in the structure on income taxes (New Income Tax Act of 1969) and increases in wages and salaries resulted in an increase in the demand for locally and imported goods.

3. Social policy

Explicit attention was paid to social policy in the early post-independence Budgets. A social security scheme was started in 1967. Sickness and funeral benefits were introduced along with maternity benefits in 1968, old age contributory and invalid survivor benefits in 1968 and pensions in 1970. In 1971 social security pensions received in Barbados were exempted from income tax along with pensions payable under the National Insurance Scheme. By March 1969, Bds$ 156,352 were paid out in benefits under the Social Security Scheme.

Budgetary policy had social effects by way of changing the distribution on income. Holder and Prescod (1989) indicate that the progressive income tax system reduced the overall level of inequality during the late 1960s and early 1970s. In general, the middle income groups were favoured by the changes in the income structure.

The early post-independence period was therefore characterized by budgetary measures to enhance economic development (diversification of the production structure), to deepen inter-regional trade and to assist social welfare. The main problem facing the Government during the period was the relatively high rates of inflation occasioned by the devaluation of the dollar. Probably a central feature of the period was the emphasis on deficit budgeting, whereby the Government planned expenditure exceeded its planned collection of revenue. Such an approach to public budgeting not only had employment effects, but also impacted adversely on the BOP.

C. The post-'oil crisis' period: 1973-1988

The year 1973 can be considered a turning point in fiscal management in Barbados (see also Howard, 1982). In the 1973 Financial Statement and Budgetary Proposals, it was stated that all "available indicators point to the fact that (the) economy (was) undergoing a process of transformation" (p. 5). The April 1974 Statement also noted that "1973 was the last year of the past" and "1974 was the first year of the future" (p. 35). The Central Bank, established in 1972, became fully operational in 1973 with the issue of the Barbadian dollar to replace the East Caribbean dollar in the money market. The Caribbean Community and Common Market (CARICOM) was established by the Treaty of Chaguaramas in August 1973. The members of the integration movement were committed to the introduction of a common external tariff on extra-regional imports. Britain fully entered the European Economic Community in January 1973. In October 1973, the international oil cartel, OPEC, announced price increases which significantly disrupted the international economy (i.e. the co-called "oil crisis"). The major industrialized or developed countries adopted a floating exchange rate regime. The events of 1973 significantly altered the nature of budgetary policy in Barbados. Although the Government was faced with a narrow tax base, the lack of a developed capital market and the uncertainty of tax receipts from exports, it could now use money creation, i.e. borrowing from the Central Bank, to finance its fiscal deficit. It could not change import duties on extra-regional imports unilaterally with the existence of a Common External Tariff structure. It also had to face the implications of a substantial increase in the price of imports, especially oil-based products.

1. Development policy

Between 1973 and 1976 little explicit emphasis was placed on development policy since the focus of budgetary policy was on a stabilization policy occasioned by the oil price increase of 1973. The Government continued to finance its capital expenditure through foreign project loans. Development policy continued to be focused on import substitution in agriculture and manufacturing by means of increases in import duties in line with Common External Tariff as well as embargoes, licensing and quantitative restrictions on imports. The intensification of intra-regional trade was expected to increase production and employment. The fiscal incentives to industry were brought under one regional scheme, i.e. the Harmonization of Fiscal Incentives Act 1974.

A more comprehensive approach to public budgeting was adopted after 1976 with more detailed budgetary documents incorporating a wide range of taxation and expenditure measures. The Government's capital works programme continued to be focused on the development of the social infrastructure. Projects in the area of education and training, agricultural diversification and manufacturing development were also undertaken. Although the Government sought to promote import substitution, especially in agriculture through a series of fiscal incentives (for example, land cultivation rebates, grants for spraying equipment, irrigation facilities and the establishment of orchids and silos), greater attention was paid to export promotion.

In a small developing economy, exporting is an essential aspect of macro-economic policy. The small domestic market for a range of goods and services

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limits the extent to which import substitution can be pursued. In the past, the Government had used commercial policy in terms of increasing import duties to protect local industry. With the imposition of the Common External Tariff within CARICOM, reliance was placed on such fiscal measures as increased consumption taxes and stamp duties in order to reduce the demand for imports and encourage domestic production. However, there was a need to encourage exports to generate the foreign exchange in order to purchase goods and services which could not be produced locally.

In 1979, the Export Promotion Agency was created to provide businesses with information on export opportunities. The Income Tax Act allowed for a rebate on a graduated scale of up to 59% of a domestic manufacturer's tax so long as his/her extra-regional sales accounted for more than 61% of total sales. In 1977 it was reported that no local business was able to qualify for such rebate. In 1985, the maximum rebate was increased from 50% to 80% in an effort to encourage domestic procedures to export extra-regionally. Other measures introduced to promote extra-regional exporting were an allowance for market research and development of 150% of actual expenditure incurred and an initial allowance of 40% on the purchase of new capital equipment. An agricultural export revolving fund was established with an initial sum of Bds$ 1 million to provide loans to those wishing to export non-sugar agricultural products. The market development allowance was also extended to the tourism sector. In addition to those budgetary measures, the Central Bank established an Export Credit Insurance and Guarantee Scheme to provide greater support for exporters. Whilst budgetary policy has sought to encourage extra-regional export, many of the barriers to such exports still remain, e.g. protectionism in more advanced economies, the existence of non-tariff barriers and high quality standards. These barriers cannot be removed by budgetary policy; political action on an international scale would be required.

The Government also sought to develop offshore financial services by providing a number of tax exemptions to offshore banks and other financial institutions. These exemptions relate to required reserves and specified asset and capital requirements, interest rate ceilings and lending restrictions.

An important developmental aspect of budgetary policy, especially after 1976, was the emphasis on mobilizing domestic savings for investment purposes. In addition to changes in the personal income tax structure which increased nominal disposable incomes and hence savings, a number of fiscal measures were introduced to encourage domestic savings. The Government declared 1979 as "National Savings Year". Schemes for boosting national savings included the issue of national savings certificates and tax certificates, the introduction of a secondary market for mortgages, a tax allowance for saving with credit unions, income tax deductions for new shares purchased in public companies, a check-off system to permit the purchase of development bonds by public servants on an instalment basis, the introduction of a bonus share scheme and increased allowances for life insurance premiums and registered retirement plans. The transaction cost of transferring shares was reduced and national housing and development bonds were introduced in an effort to develop the local capital market. The establishment of a Securities Exchange provided an avenue for investing in a number of public companies. The Government therefore provided "the appropriate incentives not only to encourage domestic savings but furthermore, to channel the available funds into the productive sectors" (Budget 1984, at 11).

Government's budgetary policy in the post-1976 period was largely to stimulate employment by creating an environment conducive to stronger export-led growth, and one in which domestic savings can be "expanded to finance renewed investment" (Budget 1984, at 9).

By providing a range of fiscal and monetary incentives to the private sector, the Government's approach to employment creation was largely "indirect" or "indicative". In 1977, the Government introduced an employment levy which was designed to increase employment in the private sector. The levy involved the granting of tax credits "proportionate to an increase in the number of workers employed during the lower year" and was "related to wages paid in such a way that lower paid workers (would) reap the greatest benefits from the implementation of an expansion policy by an employer" (Budget 1977, at 11). Evidence provided by the Government indicated that the main areas of employment growth as a direct result of the levy were construction, distribution, hotels and general services. The Employment Levy was replaced by a Training Levy in 1981. Funds obtained by the imposition of this new levy were expected to enhance the human resource development of the country. The Employment Levy was reintroduced in 1987 in an effort to "finance specific programmes relating to new job opportunities".

Attention was also placed on improving operational efficiency in both the public service and statutory corporations. The Barbados National Bank was formed in an amalgamation of some of the Government's financial institutions. Measures were also taken to reduce tax evasion and improve the general tax collection process.

The developmental aspect of the Government's budgetary policy in the 1973-1988 period therefore concentrated on boosting domestic savings and investment, encouraging export promotion and providing incentives to the private sector to generate employment. There was a general shift of taxation away from direct to indirect taxation. This shift was partly designed to increase disposable income and hence aggregate domestic demand and savings. Output and employment expansion were expected to emerge from such a taxation policy.

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2. Stabilization policy

Issues of economic stabilization actively occupied the Government's attention during the post-1973 period. During the period, supplementary budgetary proposals were presented twice, 1974 and 1981, when the economy was experiencing serious balance of payments and fiscal deficit problems.

The Government sought to lessen the pressure on the BOP by a combination of fiscal and monetary measures. In addition to import restrictions and licensing measures, consumption taxes and stamp duties were progressively increased on imports to reduce the demand for imports through the price effect. The base of the consumption tax computation was changed in 1981 to include the import duty. The Government sought to control its expenditure by streamlining both current and capital expenditure. Wage and salary increases were constrained in an effort to lesson the Government expenditure effect on BOP. Credit restrictions and stringent exchange controls were, however, the main policy measures used to contain imports. As indicated in the previous section, efforts were made to boost domestic exports to extra-regional markets.

While a windfall gain in export sugar earnings enabled Barbados to realize a BOP surplus in 1975, there was a complete reversal of the payments position in 1976 as net capital inflows were unable to offset the substantial deficit on current account. Tight credit, import and foreign exchange restrictions were introduced. In January 1977, the Government was forced to borrow under the Compensatory Financing Facility of the IMF because of the "anticipated shortfall in receipts from the export of sugar" (Budget 1977, at 19). The Government was again forced to borrow from the IMF in October 1982 when there was a significant deterioration in the BOP in 1981. Under the Standby Agreement, Barbados was required to satisfy certain performance criteria with respect to the extension of domestic credit, the level of foreign debt and Government borrowing from the banking system.

The approach to inflation brought about by the increases in petroleum prices by OPEC was largely accommodating. The Government announced increases in the retail price and tax on petroleum products (i.e. gasoline and diesel fuel) in an effort to encourage conservation. Selective price controls on essential goods were used to protect fixed- and low-income individuals from the adverse effects of inflation.

Controlling the fiscal deficit was a major concern of the Government during the post-1973 period. During the periods 1973-75, 1976-78, 1981-83 and 1984-85, the Government experienced significant fiscal deficits. These deficits were due to sluggish revenue growth and significant increases in expenditure, especially on the capital account. The periods, 1978-79 and 1982-83, were characterized by substantial reductions in capital works expenditure.

A wide range of tax measures were introduced to increase Government revenue. Among the main tax measures was the introduction of a sales tax on a large number of goods in the Supplementary Budgetary Proposals of 1974. This tax was later abolished in 1976. Greater emphasis was placed on consumption taxes and stamp duties as revenue-raising measures although these taxes were also designed to promote import substitution. The corporation income tax structure was also adjusted. A number of special levies were introduced – Employment, Health, Transport and Training – and the funds earmarked for employment generation, training, the development of a national health system (e.g. a National Drug Service), the purchase of equipment and buses and road repairs. Water rates and bus fares were progressively increased to defray the costs of providing these services. The Sugar Levy was increased to provide funds for various social programmes (e.g. housing).

On the expenditure side, the Government sought to control the growth of both its capital and current expenditure. Salary and wage increases were legislated in 1976 and in 1980 in an effort to control current expenditure. The Government was determined to "finance a reasonable proportion of capital expenditure through public savings" by a deliberate policy of restricting the growth in current expenditure (Budget 1977, at 5).

The financing of the fiscal deficit was undertaken primarily through borrowing from the banking system (both commercial and the Central Bank, the National Insurance Fund and project loans). With the establishment of the Central Bank, the Government was able to borrow funds on a short-term basis to finance its deficit. Project loans were used primarily to finance capital works expenditure in the public sector.

The general thrust of fiscal policy in the post-1973 period was the shift of taxation from direct to indirect measures. Between 1977 and 1985, a system of tax credits was introduced for those receiving an income below a specified level. In 1986, a significant change in personal income taxation occurred when those with a total assessable income below Bds$ 15,000 were not required to pay income tax. During the period, allowances were raised and tax rates and bands were changed in order to increase personal disposable income. Some of these income tax changes were partly a result of the effects of inflation which significantly reduced the purchasing power of individuals faced with a highly progressive income tax structure. The corporation tax structure was also changed to allow companies to reinvest more of their profits. These income tax changes were partly designed to increase investment, output and employment by increasing the purchasing power of individuals.

The stabilization aspect of budgetary policy in the post-1973 period therefore centred on controlling the deficits on the public sector account and the BOP. The approach to inflation was largely accommodating since the Government was unable to influence the external factors accounting for the high rates of inflation. The measures used to contain the fiscal deficit involved increases in indirect taxes and fees and controlling the growth of expenditure. Both monetary and fiscal

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policies were used to reduce the BOP deficit, with the Central Bank playing an active role in the process.

3. Social policy

One of the objectives of budgetary policy was the promotion of greater social equity in the tax system by increasing disposable income of low-income earners through the system of tax credits (Budget 1980, at 9). Pensions were progressively increased during the period as inflation had its greatest impact on fixed-income earners. Funds from the various levies – health, sugar, transport – were used to improve such social amenities as housing, public transport and health. A number of programmes were put in place to "provide direct assistance to persons over 65 – free bus transportation, free duty service and assistance with the payment of water and electric rates, among others" (Budget 1984, at 15). An Unemployment Insurance Scheme was introduced in 1981 to provide benefits for the unemployed while they are seeking new employment. School children were granted free school meals and subsidized text books. The Government also sought to provide housing accommodation for the population. Funds were channelled to financial institutions to provide housing finance for low and middle income-earners. Special income tax concessions were granted to house builders and the method of taxation applied to owner-occupied housing was restructured. Mortgage interest payments were partly deductible from income taxation.

V. CONCLUDING EVALUATION

The primary objective of this paper is to review budgetary theory and policy over the period 1960-1988, to identify any trends with respect to developmental, stabilization and social aspects of budgetary policy. The review is based principally on the Financial Statement and Budgetary Proposals of the Government during the period. In order to facilitate the discussion 3 periods are identified: the pre-independence period, 1960-1966, the early post-independence period, 1967-1972 and the post-1973 period.

Budgetary policy operated within certain constraints. Prior to the establishment of the Central Bank, the extent to which the Government could finance a fiscal deficit was constrained by the existence of a colonial monetary system based on a currency-board arrangement. Even with the establishment of the Central Bank, the Government was constrained in its use of Central Bank funds since such borrowing would have exaggerated the BOP deficit. The Government had little or no control on the externally-induced inflation rate, hence its approach was largely accommodating. Government expenditure had to be controlled to avoid further BOP problems. At the same time, the Government had to be mindful that its reduction in expenditure did not adversely affect the provision of essential social amenities. The measures had to be designed to minimize the effect on the cost-of-living, especially in an inflationary period.

The main features of budgetary theory and policy during the period discussed are as follows:

(1) Expenditure policy was directed towards developing the social infrastructure, i.e. the road system, sea and airport, in order to facilitate the production process in the private sector.

(2) Incentives were granted to industries to promote import substitution in the 1960s and early 1970s. However, given the small size of the domestic market and trading problems in the regional market, budgetary policy focused on extra-regional markets.

(3) There was a strong reliance on the private sector to provide employment in the country. Several incentives were granted to businesses to employ more persons.

(4) Some emphasis was placed on mobilizing domestic savings for local investment purposes. Saving instruments and tax credits were introduced to boost the savings capacity of the country.

(5) Budgetary policy was geared towards containing both the fiscal and BOP deficits. Prior to the introduction of the Common External Tariff, import duties and, to a limited extent, income taxation were used to reduce both deficits by means of the price effect of import duties and the deflationary effect of increases in income taxation. In the post-1973 period, greater reliance was placed on consumption taxes and stamp duties, as revenue from import duties was reduced. Credit policy was used extensively to reduce the importation of goods. Greater control of government expenditure growth was adopted.

(6) Social policy was geared towards increasing the income of the poor – increased pensions and tax credits and the provision of such social amenities as health, education, housing and transport.

(7) Finally, whilst the general emphasis was a development policy in the pre-1973 period, stabilization policy was a major concern in the post-1973 period as the Government grappled with the problems of sluggish growth, BOP deficits, fiscal deficits and inflation.

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The Tax System of Barbados

DeLisle Worrell

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INTRODUCTION

Barbados is the most easterly of the islands of the Caribbean chain, which stretches in an arc from the Gulf of Mexico to the mouth of the Orinoco River in northern South America. The island has an area of 430 square kilometres and a population of 250,000. It is in the middle ranks of developing countries, with a per capita GDP in 1988 of about US$ 5,500. The Government is a parliamentary democracy, with elections held at least every 5 years. There is a single Government authority and it budgets on an April-March fiscal year. Some changes in the tax system are introduced in each year's Budget, usually presented to Parliament in April. The system described in this paper is as it existed in January 1989.

Growth in the Barbados economy is driven by 3 sectors which earn foreign exchange for the purchase of the variety of producer and consumer items which Barbadians import. Tourism, exports of light manufacturing and sugar exports provide for about one third of value added in the economy; the remainder is contributed by Government services, wholesale and retail trade, financial and personal services and construction. Tourists come to Barbados from North America and the United Kingdom, for the most part. Manufactured goods are sold mainly to the country's neighbours in the Caribbean and sugar is sold mainly to the United Kingdom under the provisions of the Convention of Lomé.

The 1980s have been a period of extended adjustment for Barbados, following a recession associated with the second oil crisis and the world recession of 1979-81. In 1980 and 1981 the economy contracted, levels of unemployment rose, prices rose rapidly and a considerable deficit appeared in the balance of external payments. Measures were taken to restrict expenditures in 1982 and 1983, and borrowings were negotiated under a standby arrangement with the In-

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ternational Monetary Fund (IMF). Private foreign borrowing was undertaken after the IMF programme ended. Output growth was restored from 1983 onwards and inflation was arrested, but levels of unemployment remain high.

AN OVERVIEW OF THE TAX SYSTEM

Taxes on domestic goods and services (25% of tax revenues in 1987/88 and on imports 24%) are the largest sources of Government revenue, followed by taxes on income and contributions to the National Insurance Scheme (18% each). The most important taxes, and their contributions to total tax revenue, are shown in Table I. There is a general consumption tax imposed on domestic goods and services and a sales tax is imposed on hotel and restaurant sales. On imports there is a customs tariff and a stamp duty. There are taxes on personal and corporate incomes, and additional levies on individual incomes and on wage payments by companies. Social security contributions are required for health services and unemployment benefits. Provision is made for tax exemption of specific types of economic activity which the Government wishes to promote, mainly investment and offshore business by companies from industrial countries. Overall, taxes were the equivalent of 27% of 1987 GDP at market prices.

Table I

Tax revenues by source 1987/88

	$ million	% of revenue
Taxes on income and profit	162	18
Personal income tax	53	
Corporation tax	73	
Other taxes on firms	10	
Transport levy	19	
Training levy	7	
Social security taxes	160	18
NIS	122	
Health levy	28	
Unemployment levy	10	
Taxes on domestic commodities	227	25
Consumption tax	152	
Hotel, restaurant tax	16	
Other	59	
Taxes on imports	216	24
Property taxes	36	4
Total taxes	801	
Other revenue	112	12
Total revenue	913	100

Source: Central Bank of Barbados.

The relative importance of various taxes is similar to some other developing countries, and rather different from the patterns observed in industrial countries. Barbados and other LDCs depend much more heavily on taxes on trade than is typical of industrial countries. The country's small size also contributes to the prominence of trade taxes; large LDCs like Brazil derive only a small proportion of revenue from trade taxes. Barbados and other LDCs gather a smaller proportion of revenue from social security schemes, which are more highly developed in industrial countries. LDCs, Barbados included, tend to collect a smaller proportion in income taxes than do more developed countries (MDCs). In many countries this is a result of inadequate machinery for collecting income taxes, which require more sophisticated record keeping than do taxes on trade. In Barbados' case the lower proportion is the result of deliberate policy, since the late 1970s, to arrest growth in the share of income taxes in national income.

Tax administration is in the hands of several Government offices. The Income Tax Commissioner administers the income taxes. Returns on income are required from all individuals by the end of April each year; returns from companies are due by 15 March. Employees make payments from each paycheck (under the PAYE system), while companies are required to make payments twice a year. Companies may purchase interest-bearing tax reserve certificates in advance, to mature at the time their tax liability comes due. The Comptroller of Customs administers the customs duty, the consumption tax, the stamp duty on imports and the excise tax. Payments are recorded at the time of the transaction, and the returns sent immediately to the Comptroller's office. The Commissioner of Land Tax collects the property tax and the tax on residential subdivisions. Payment of property tax is required within one month of the issue of assessment notices at the end of each calendar year. The Office of the Registrar collects property transfer taxes and some stamp duties on services. Stamp duties on documents are collected by the Post Office and the Treasury. National insurance contributions and levies are paid to the National Insurance Scheme (NIS), which operates as a separate Government entity, with its own board of directors. The licensing authority collects various fees and charges.

Companies which qualify for exemption from taxes, fees and charges must be certified by one or more of a variety of institutions, depending on the nature of their business.

Manufacturing concerns apply to the Barbados Industrial Development Corporation, farmers to the Ministry of Agriculture, hotels to the Barbados Board of Tourism, financial institutions to the Central Bank of Barbados and insurance companies to the Office of the Supervisor of Insurance, a division of the Ministry of Finance.

CHANGES IN THE RELATIVE IMPORTANCE OF TAXES

Taxes on imports were more important than all income taxes (personal and corporate) in the 1960s, but they were overtaken by income taxes in the 1970s. The

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growth of direct taxation (income taxes, NIS contributions and levies) slowed in the 1980s, and the NIS contributions rose in importance relative to taxes on income. Taxes on domestic goods and services rose from a small contribution in the 1960s to become a major source of revenue from the 1970s onward.

The principal changes in import taxes were the introduction of a common tariff for Barbados and other members of the Caribbean Economic Community (Caricom) in 1973 and the introduction of general stamp duties on imports in 1982. The Caricom Common External Tariff (CET), imposed on imports from all non-member countries, raised Barbados' tariffs on a number of items. All imports from member countries may be imported free of duty.

The introduction of the National Insurance Scheme in 1967 was the most important innovation in income taxation. By 1988 the NIS had grown to be as important as the income taxes. The level of income taxation was reduced in a series of adjustments to the rates and to the deductible allowances between 1978 and 1986, though the effect was attenuated by the simultaneous introduction of levies.

Prior to the introduction of general consumption taxes in the late 1970s there were only minor charges, excises and fees on domestic goods and services. The hotel and restaurant sales tax was introduced in 1974.

The ratio of tax revenues to GDP rose from 15% in 1963 to 26% in 1979; it leveled off in the 1980s. Provisional measures of individual tax rates have been made by the present author (Worrell, 1988 at 8-11) for the period 1960 to 1986. The rate for the personal income tax, exclusive of levies, was 6% of GDP on average for the period as a whole, starting at 3% in the early 1960s and reaching 8% in the 1970s, ending at the average rate. Corporate taxation, again exclusive of levies, was about 3% of GDP on average, with only slight variation. Import duties, not including the stamp duty on imports, were calculated at a rate of 9% of imports, though the results suggest this is somewhat of an over-estimate. The rate on domestic goods and services averaged 7% of GDP, ending at 10.6% in 1986. No estimates were made for the NIS contribution.

TAXES ON PERSONAL INCOME

Residents of Barbados are subject to taxation on income from employment and property, including returns on financial assets, but not including capital gains. The rate is graduated up to a maximum of 50% on each extra dollar for taxable income in excess of Bds$ 55,000 (US$ 27,500; the Barbados dollar, Bds$ or Bbd$, was worth 50 U.S. cents in January 1989. In this article amounts are quoted in Bds$ unless otherwise stated). Taxable income is gross income less personal allowances, allowances for dependents, selected expenses for the welfare of the household (health, insurance premiums, education, owner-occupied housing and related expenses), and special allowances to encourage savings. Each taxpayer is allowed to deduct at least $ 15,000 in this way and no income tax is due if the annual income is $ 15,000 or less. National insurance contributions and contributions to pension schemes approved by the Commissioner are also deducted in the calculation of taxable income. Individuals may claim 15% of an ordinary dividend received as a tax credit (effectively an allowance). Companies are required to pay a tax of 40% from the amount of any preference dividend before distribution; this is regarded as a payment on the recipient's behalf, and he records it as such on his personal income tax return, adjusting his remaining tax liability accordingly.

The progression in the income tax system occurs in the middle of the earnings distribution. The average wage earner pays no income tax (although he must make a NIS contribution). The $ 15,000 income, above which one becomes liable to income taxation (at a marginal rate of 20%), is just above the average wage, estimated by Whitehall & Crookendale (1988) at $ 12,500 in 1987. We reach the highest marginal rate (50%) at a wage that is 5 times the average. In a sample of industrial countries reported on by Hagemann, Jones & Montador (1987, at 188-190), the individual becomes liable to tax at a wage which is only one half the average in most cases, and the 50% marginal rate (where it applies) cuts in at a lower multiple of the average wage. The marginal rate rises above 50% in all the countries of the sample except the United States and Canada (and, since 1988, the United Kingdom). In a study which ends in 1981, Holder and Prescod (1984, at 370) found that the income tax significantly reduces the index of income inequality, a result which undoubtedly still holds true.

The National Insurance Scheme collects contributions and levies from income earners and self-employed persons at rates of 9.75% and 13.75%, respectively, of gross income. No contribution is made on any income in excess of $ 31,200 per annum, so that the maximum contribution is $ 3,042 for employees, irrespective of the level of income. In addition, employers pay levies and NIS contributions of 8.25% of salary for each worker, with the same limitation on the maximum income as for the worker's contribution. Because of the high threshold for payment of income tax NIS contributions are the main form of tax on income for most of the population. It has a slightly regressive effect, according to Holder and Prescod, neutralizing a little of the effect of the personal income tax.

There are levies on gross income for funding an unemployment benefit scheme and a vocational training scheme. There are also 'health' and 'transportation' levies, but receipts are added to the pool which funds general Government expenditure. Contributions are made by employers as well as employees, with rates as shown in Table II. The maximum income used for calculating all levies is the same as that stipulated for NIS contributions. There was an additional income surcharge of 5% – rising to 7% on marginal income above $ 50,000 – legislated for fiscal year 1988/89 only. The unemployment fund pays eligible workers (those

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Table II

National insurance contributions and levies
% of gross income

	Employee	Employer
National insurance		
Health insurance	5.00	5.00
Injury	—	0.25
Unemployment	0.50	0.50
Severance	—	0.25
Levies		
Health	1.50	1.00
Training	0.50	0.50
Transport	1.75	0.25
Employment	0.50	0.50
Total	9.75	8.25

Source: National Insurance Scheme.

Table III

Rates of consumption tax
(Percentages, lowest to highest)

Consumer goods	
Food	0-25
Durables	9-25
Non-Durables	9-35
Motor cars	50-70
Raw materials	9-15
Machinery	20
Other capital goods	15-35

Source: Excerpted from the Consumption Tax Schedule.

who have been in continuous employment over a stated period) a proportion of their wages for a fixed period if they are laid off.

TAXES ON CORPORATE INCOME

Resident corporations pay tax at the rate of 35% of profits. Insurance companies pay a tax on premium income and the rates of taxation on the profits of mortgage companies and building societies are 12.5% and 20%, respectively. Banks doing business in Barbados also pay a small tax on their assets. Companies pay an additional 8.25% of their employment costs in the form of NIS subscriptions and levies noted above. Deductions which are generally available to any firm include investment incentives and rebates on marketing and research activities. There is a special tax regime (described below) for offshore companies, i.e. companies resident in Barbados which engage exclusively in business outside the island. There are also special regimes for new companies, and for firms engaged in exports, tourism, manufacturing and agriculture. They may obtain exemption from corporation tax for specific periods, so as to secure a sufficiently high rate of profit in the formative years. They may also qualify for relief from import taxes, allowing them to purchase inputs at world prices so as to maintain international competitiveness. All companies are allowed to carry forward a portion of losses to be set off against profits up to 5 years in the future. Companies are not required to withhold any taxes on dividends paid on ordinary shares; 40% of dividend payments on preference shares is withheld, but earners may offset this against their total tax liability. A tax of 15% is withheld on dividends paid abroad, though many companies obtain exemption from this provision when they qualify for one of the special tax regimes mentioned earlier.

TAX ON PROPERTY

Property owners must pay a tax at the rate of 0.4% of properties with buildings erected on them (referred to as 'improved' land). Land on which there is no building is taxed at a rate of either 1.25% or 2%, depending on value. Farmers may obtain exemption on land used for agriculture. A land development tax is charged on the appreciation in value of land which is subdivided for residential use. There is a tax for the transfer of ownership of property, equal to 5% of the value of the property, for all sales, deeds, gifts, etc. In addition, foreigners must pay a 10% tax on purchases of local property.

TAXES ON DOMESTIC GOODS AND SERVICES

A consumption tax is imposed on the 'market price' (defined in the law) of domestic goods and on the combined import price and customs duty for imports. The rates of taxation are graduated, with exemption for basic foods, low rates for raw materials and capital goods, high rates for consumer durables and extremely high rates for alcohol, cigarettes and motor cars. The ranges are shown in Table III. Offshore companies and companies benefiting from fiscal incentives are exempt as are raw materials used in the manufacture of items subject to consumption tax (so as to avoid pyramiding). Also exempt are items for duty-free sale to visitors, ship's stores and bunkers, and re-exports.

Excise taxes are levied only on domestic sales of alcoholic beverages, in the form of fixed charges per litre.

The hotel and restaurant sales tax is imposed at 5% of the value of hotel room charges and restaurant bills.

There are a variety of stamp duties imposed on domestic services. They take the form of charges on legal documents and on financial instruments which evidence the transaction. The rates are less than 1% of the value of the transaction or a fixed dollar amount.

Other taxes on goods and services include an airport service charge of Bds$ 16 per person, paid by each

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departing passenger, a tax paid by companies offering services to airlines, a 15% tax on the purchase of airline tickets, a tax on oil drilling operations, and miscellaneous licence fees and charges for services provided by Government such as the issuance of official documents.

TAXES ON TRADE

There is a customs duty on imports from non-Caricom countries, with rates set in conformity with the common external tariff agreed among Caricom members. There is also a stamp duty on imports, at the rate of 15% of the CIF value. Imports from Caricom countries are exempt only if the supplying country imposes no stamp duty on its own imports from Barbados. The rates of customs duty vary on the same principles as for the consumption tax, with basic foods exempt and high rates on consumer durables and non-essentials. Exporters, new industrial firms, farmers and offshore business companies are all eligible for exemption from the customs tariff, and no stamp duty is to be paid on raw materials for the manufacturing sector.

PROVISIONS FOR TAX RELIEF

There are laws providing for relief from a variety of taxes and charges for manufacturers, exporters, hoteliers and farmers.

Manufacturers may qualify for exemption from the corporation tax for a specific period under the Fiscal Incentives Act, 1974. Companies which export outside the Caricom area are permitted 10 years of tax-free operation. Other manufacturing concerns may obtain tax exemption from 6 to 10 years, depending on the proportion of the value of the product that is added locally. These companies may import raw materials and capital goods free of customs duty, stamp duty and consumption tax. They may rent low cost factory space from Government's Industrial Development Corporation, and Government financial assistance is available for training of personnel.

Exporters to non-Caricom countries may obtain a rebate of up to 80% of corporation tax that would have been paid on their export operations after the end of their tax holiday. At the current 35% rate of corporate tax this would reduce the tax rate on export profits to 7%, at the lowest.

Dividends of those manufacturing or exporting companies that qualify for incentives may be remitted abroad without incurring the 15% tax, provided they will not be taxed in the country to which they are sent. If they are subject to a foreign tax, the withholding tax is imposed in Barbados at the lower of the Barbados and foreign rates. Art. 10 of the Double Taxation Treaty with the United States provides for exemption from the U.S. tax on accumulated earnings.

The Hotel Aids Act allows hotels to write off their capital expenditure fully in one year or to carry forward the expense against profit for up to 9 years, as they prefer. There are also provisions for duty-free imports.

Farmers may secure imported raw materials and capital goods free of customs duty, stamp tax and consumption tax. Government provides financial and technical services to farmers, but there is no specific provision under which they may obtain exemption from the corporation tax for any period. Like any other company they may carry forward losses against future profits for up to 5 years.

INCENTIVES FOR OFFSHORE BUSINESS

Barbados' legislation includes incentive regimes for several types of offshore business, where firms locate offices in Barbados to provide services exclusively to clients overseas.

Exempt insurance companies do business only with large corporate clients. Often they are subsidiaries of global corporations, established solely to provide in-house insurance, although there are an increasing number of independent companies providing, for example, insurance against malpractice suits. Barbados' Exempt Insurance Act 1983 allows companies registered in Barbados and wholly-owned by non-Caricom citizens to provide insurance services outside Caricom with no tax on their profits (and no requirement to seek permission from the Central Bank of Barbados to effect foreign currency transactions). The firms are required to pay a licence fee and an annual registration fee, and at least one of their directors must be a resident citizen of Barbados.

International business companies are firms incorporated or managed in Barbados to provide trading or investment services exclusively for non-residents of the Caricom area. They are taxed at graduated rates starting at 2.5% of profits and falling to 1% as profits increase. Their non-Barbadian staff may earn 35% of their salary tax-free, to be paid in foreign exchange. U.S. legislation provides incentives for firms registered as Foreign Sales Corporations to provide services from offshore locations in the Western Hemisphere. Barbados has legislation for the local registration of such firms. They pay an annual licence fee but they are not taxed.

Offshore banks are registered in Barbados to do business elsewhere. They pay taxes on the same 2.5% to 1% sliding scale as for international business companies, and their non-Barbadian staff are entitled to the 35% tax-free concession. They must employ at least one resident Barbadian on their board of directors.

There is also a Shipping Incentives Act which provides a 10-year tax exemption on profits for any ship registered in Barbados, or for any company engaged in leasing, building or maintenance of ships. Registration fees are linked to ship tonnage. This is the one area of offshore business where there has been no activity.

DOUBLE TAXATION TREATIES

Barbados has negotiated treaties to attract foreign investment by providing double tax indemnity with the United States, the United Kingdom, Canada and the

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member countries of Caricom. In most cases lower rates of withholding tax apply. A treaty originally negotiated by the United Kingdom with Switzerland when Barbados was still a British colony remains in force and treaties with Norway and Finland were initialled early in 1989.

The Caricom tax sparing treaty was signed at the time of the inauguration of the Caribbean Community in 1973. It covers income and corporation taxes and recognizes tax sparing provisions under all incentive legislation in force in member countries. Dividends paid to an individual in a second Caricom country do not attract tax if the activity from which they arose in the first country is tax-exempt. Nationals in any State must not be subject to a greater burden of taxation in a second State than nationals of the second State.

The treaty with Canada provides that businesses be taxed in the country where there is a 'permanent establishment'. Where profits made and taxed in one State are reported in the second State an appropriate offset is to be made. Rates of taxation on remittances are set at 15% for dividends and interest, 10% for royalties and 15% for management fees.

The treaties with the United States and the United Kingdom make similar provisions, but the prescribed tax rates vary. For the United Kingdom, royalties on cinema and TV films are taxed at 5.25% and other royalties and dividends are usually exempt. The treaty with the United States prescribes a rate of 12.5% for interest and royalties, with the tax on dividends ranging from 5% to 15% depending on the percentage of shares in the company that are held by U.S. citizens. The treaties with Norway and Finland provide for a 5% tax on dividends, interest, royalties and management fees.

SOME ECONOMIC EFFECTS OF THE TAX SYSTEM

The tax system is designed to provide strong incentives for investment, especially in exports and in import substitutes. Because of the import tariff there is potentially more tax incentive per dollar of investment in import substitutes than for exports. This does not create much of a bias towards import substitutes because of the small size of the Caricom market. The diseconomies of scale of production for the Caricom market are so severe that firms of any size will find it more profitable to produce for export markets. Typically, the scale of operations suitable for the Caricom market produces a rate of profit which is so much lower than the rate for a plant designed for export that the import tariff is insufficient to close the gap. The Caricom market therefore remains the preserve of small business. There is a high level of protection for a limited number of import substitutes such as processed foods, clothing and furniture. Ranis and Associates (1981) and Whitehall (1984) found moderate levels of protection for most items. The rates of tariff and import stamp duty together do not afford high levels of protection. The heavily protected items are those which are prohibited, of which there are only 160 items in the tariff code of 2,400 items.

The tax system as a whole seems to have a progressive impact on the distribution of income. Income distribution in Barbados is remarkably even to begin with, with coefficients of inequality comparable with those of North America and Europe (Holder and Prescod, 1984 at 369). The inequality diminishes further as a result of the structure of the personal income tax. Levies, NIS contributions and indirect taxes are only mildly regressive, and do not neutralize the effects of the personal income tax.

SUMMARY

The 4 major sources of tax revenue in Barbados are taxes on domestic goods and services and imports, each contributing about one quarter of revenues, and income taxes and national insurance contributions, each accounting for somewhat over one third. There are regimes for exemptions for investment, new enterprises, exports and offshore business. The main changes in the last 2 decades have been the growth of the NIS, the imposition of significant taxation on domestic goods and services and the introduction of the Common External Tariff among countries of the Caribbean Community. The tax burden was on the increase up to the late 1970s but since then it has remained unchanged. The NIS is the main tax on wage earnings; the average wage earner is below the threshold for the personal income tax, which is progressive in the middle range of incomes. Tax rates on imports and domestic goods and services are graduated, with basic consumer items exempt, low rates on producers' goods, high rates on consumer items and penal rates on some 'luxuries'.

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BARBADOS:

Developments in the Offshore Financial Sector

Bruce Zagaris

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Two developments indicate the Barbados international financial sector's maturity: the Prime Minister's Budget Speech and proposals to develop the sector and the formation of a branch of the International Fiscal Association (IFA).

BUDGETARY STATEMENT

A. Growth of the offshore financial sector

According to the 29 April 1989 budgetary statement of The Right Honorable L. Erskine Sandiford, Prime Minister of Barbados, Barbados has experienced significant growth in serving as a center for international business services. At the end of 1988, there were 6 licensed offshore banks with assets of Bds$ 2,240 million and 41 new foreign sales corporations, bringing the total of such companies to 263. At the end of 1988, 156 exempt insurance companies were registered, an increase of 46 from the previous year. Thirty-eight exempt insurance management companies operated, as compared to 28 in 1987. The Prime Minister estimated that revenue accruing to the Government from fees, licences and taxes on international companies was Bds$ 10 million in 1988 while the total contribution of the sector to Barbados' foreign earnings was approximately Bds$ 40 million.

B. Government efforts to support the offshore sector

Prime Minister Sandiford stated that the Barbados Government will continue "to provide a supportive environment for active businesses to pursue legitimate objectives". One immediate step is the creation of an umbrella body known as the International Business Advisory Committee composed of professionals, representatives of diverse types of offshore business and Government to advise on existing legislation and incentives, and on all other factors affecting Barbados' competitiveness.

A second step for Barbados, according to the Prime Minister, will be to continue to expand its network of double taxation treaties. The Government has already initialed treaties with Sweden, Norway and Finland. Negotiations are scheduled with the Federal Republic of Germany for later in the year. According to the Prime Minister, negotiations have begun with the United States, which unilaterally removed the exemption on U.S. insurance excise tax.

A third step for Barbados, which the Prime Minister stated must be considered in very close consultation with the offshore businesses, will be "the revision of the legislation regulating various kinds of activities to provide a range of options best suited to the tax planning objectives of any particular company". In particular, he mentioned that the Government will undertake a major review of the International Business Companies to address, inter alia, a licensing arrangement for international business companies, and the conditions under which persons who may be resident in Barbados for specific reasons could establish an international business company, without violating the integrity of the domestic tax administration. The Prime Minister stated that Barbados must have flexibility and respond quickly to changing tax laws in all major countries. The budgetary proposal contains various measures to stimulate international activities in Barbados, both in the manufacturing and the services sectors.

The 1988 Barbados Economic Report 1988, which was presented by the Prime Minister to the legislature at the time of his Budget Speech, also provides statistics on and developments in the international financial services sector in 1988. For instance, it mentions that, as a step to support the sector, the Central Bank participated in the annual conference and exhibition sponsored by the Risk and Insurance Management Society (RIMS) which was held in Washington, D.C.

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FORMATION OF A BARBADOS BRANCH OF THE INTERNATIONAL FISCAL ASSOCIATION (IFA)

On 16 March 1989, Barbados held an inaugural meeting of the International Fiscal Association which was attended by approximately 40 professionals and Dick Hammer, Price Waterhouse & Co., New York and the President of IFA. An interim executive committee was formed and consists of: Dr. Trevor Carmichael, an attorney-at-law, chairman; Colin Brewer, chartered accountant at Price Waterhouse; Mary Mahabir, attorney at law, secretary; and Ken Hewitt, chartered accountant at Peat Marwick; and Rick Cunningham (Honorary Austrian Consul and president of a leading international business). IFA was formed in 1938 and has more than 7,000 members. It is the most influential, non-governmental international organization dealing with fiscal matters. Its members are taxpayers, their advisers, Government officials and university professors. The chief goals of IFA are the study and advancement of international and comparative law, especially fiscal law, and the understanding and economic impact of taxation. The Barbados branch will further these goals from the perspective of Barbados, its economy and laws.

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MEXICO:

Net Worth Tax

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INTRODUCTION

A law of 30 December 1988, published in the Official Gazette of 31 December 1988[1], introduced a net worth tax which will be payable annually by enterprises as from taxable year 1989 (assessment year 1990) together with the income tax, and is creditable against the liability to that tax. The declared purpose of the net worth tax is to improve equity and efficiency of the fiscal system and to obtain a minimum tax from those enterprises which file returns reporting no income tax liability (estimated to be 71% of enterprises in a report of a deputies' committee).

TAXABLE PERSONS

The tax is levied on:
- resident business companies;
- resident individuals performing business activities (actividades empresariales);
- non-residents with a permanent establishment in Mexico (only in respect of assets attributable to the permanent establishment);
- other persons granting the use or temporary enjoyment of goods employed in business activities by taxpayers referred to above (only in respect of such goods); and
- civil associations or companies performing business activities.

TAXABLE PROPERTY

The tax is levied on the taxpayer's average total net worth regardless of its location. However, in the case of non-residents with a permanent establishment in Mexico and persons granting the use or temporary enjoyment of goods, the tax is levied only on net worth attributable to the permanent establishment or on such goods, respectively.

EXEMPTIONS

Exempt from the tax are financial institutions, investment companies, cooperatives, small taxpayers and taxpayers subject to a special basis of taxation.[2] The tax is not levied during the pre-operation period, the period when activities are commenced, the period following and the liquidation period. This rule does not cover the periods following a merger, company transformation or business transfer.

TAXABLE AMOUNT

The taxable amount is the annual average of assets less the annual average of eligible liabilities with resident enterprises. The average of assets is the aggregate obtained after each of the following computations:

(1) the monthly averages of financial assets in every month of the taxable period are added together and the aggregate is divided by the number of months included in the period. The monthly average of assets is the aggregate of assets at the beginning and at the end of the month as divided by 2. However, the monthly average of assets corresponding to transactions made with or through the financial system is the aggregate of daily balances of the month divided by the number of days in the month.

(2) The balance of each fixed asset and deferred expense and charge, whose deduction for income tax purposes is pending at the beginning of the period, is adjusted in accordance with a factor[3] which also considers the length of time between the month in which

1. Ley del Impuesto al Activo de las Empresas.
2. The Finance Ministry is granted the authority to establish special taxation bases which represent an estimation of the net profits derived in 1989 by small taxpayers engaged in specified activities (the provision has been renewed for several years).
3. When the Income Tax Law provides for adjustment or updating of the value of goods or transactions due to the lapse of time and changes in prices in Mexico, the change is computed by using a factor calculated under the following rules: – If the period is one month, the factor for the monthly adjustment is equal to the national consumer price index of the relevant month (CPIa) divided by the index of the preceding month (CPIb) minus 1: $\frac{CPIa}{CPIb} - 1$
– If the period exceeds one month, the adjustment factor is equal to the

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the asset was acquired and the last month of the first half of the period in which the asset was used within the taxable period. The adjusted balance is then reduced by the deduction of 50% of depreciation allowances corresponding to the taxable period. The result is divided by the number of months of the taxable period and the new result is multiplied by the number of months during which the asset was used in the taxable period.

(3) The original amount of investments in each plot (terreno) at the beginning of the period as adjusted by a factor[4] which also considers the length of time between the month in which the plot was acquired and the last month of the first half of the period in which the plot was used within the taxable period. The result is divided by the number of months included in the taxable period and the new result is multiplied by the number of months during which the plot was held in the taxable period.

(4) Finally, inventory of raw materials, semi-finished or finished products used by the taxpayer in his business activity, held at the beginning and at the end of the taxable period, are valued under income tax rules, added together and divided by 2.

For the purposes of "1", financial assets include:
- cash;
- credit documents other than shares;
- receivables other than advance payments, tax balances favourable to the taxpayer and tax incentives; and
- interest accrued but not collected.

Financial assets denominated in foreign currency are valued according to the rate of exchange of the first day of each month. When the controlled exchange rate is not applicable, the average exchange rate for sales with which credit institutions of Mexico City begin their transactions is taken.

For the purposes of "2", fixed assets on which an investment allowance was taken instead of ordinary depreciation allowances[5] are computed only in the period during which ordinary depreciation allowances would be permitted had the investment allowance not been taken. In the case of the fixed assets referred to, the non-deductible part of the asset is adjusted by a factor[6] which also considers the length of time between the month in which the asset was acquired and the last month of the first half of the period in which the asset was used within the taxable period. The result is divided by the number of months of the taxable period and the new result is multiplied by the number of months during which the asset was used in the taxable period.

LIABILITIES

In calculating the taxable net worth, the taxpayer can deduct the annual average of liabilities denominated in Mexican currency with resident enterprises other than those incurred with or through the financial system. The annual average is the aggregate of monthly averages of liabilities corresponding to the taxable period as divided by the number of months of that period.

TAX RATE AND TAX CREDIT

The tax is calculated at a rate of 2%.

The net worth tax actually paid can be credited against the income tax (whether assessed on the basis of the income tax return or represented by advance payments) due for business activities of the same taxable period or the 3 following periods.

The credit balance which cannot be used in the taxable period is adjusted by a factor[7] which also considers the length of time between the last month of the taxable period in which the balance arises and the last month of the period in which it is used. The credit cannot be refunded, transferred or used to pay withholding taxes.

TAX ADMINISTRATION

Taxpayers are required to make 10 advance payments no later than the 17th of the 4th month of the taxable period and the 17th of each of the ensuing months of the taxable period.

The first advance payment is 3/12 of the tax of the preceding taxable period as adjusted by a factor[8] which also considers the length of time between the last month of the first half of the taxable period and the last month of such period. Other advance payments are 1/12 of the tax of the preceding period adjusted as aforesaid.

During 1989, advance payments are calculated on the basis of the amount of tax that would have been payable had the tax been in force in 1988.

The net worth tax is declared and paid together with the income tax return within 3 months following the end of the taxable period.

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national consumer price index of the last month of the period (CPIc) divided by the index of the first month of the period (CPId) minus 1:
$\frac{CPIc}{CPId} - 1$
The value of a good or a transaction at the end of the period is computed by using a factor equal to the national consumer price index of the last month of the period (CPIc) divided by the index of the first month of the period (CPId): $\frac{CPIc}{CPId}$

4. See footnote 3.
5. Business enterprises that acquire new assets can choose, instead of taking depreciation allowances on such assets under ordinary rules, to take in the taxable period in which the investment is made or the period in which the assets are put into use, or in the following period, an investment allowance representing a percentage of the original cost. The percentage depends on the type of asset and the type of undertaking utilizing it.
As from 1 January 1989, the allowance for investments made in the conurban zones (zonas conurbanas) of the Federal District, Guadalajara and Monterrey is reduced to 60% of its normal amount.
6. See footnote 3.
7. See footnote 3.
8. See footnote 3.

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NEW ZEALAND:

1989 Budget: Calm amidst an Upheaval

D.J. Hasseldine

Mr. Hasseldine is a full-time lecturer in Accountancy at the University of Canterbury and is the author of numerous articles.

I. INTRODUCTION AND POLITICAL BACKGROUND

New Zealand's 1989 Budget had been awaited with more than usual interest. It was the first to be presented by David Caygill; a lawyer by training, and a well respected Member of Parliament and former Minister of Health.

Caygill had succeeded Roger Douglas after the latter's long bout of infighting with the then Prime Minister, David Lange, and which culminated in Douglas' Cabinet departure late in 1988 – followed soon after by the dismissal of another high-ranking Minister of the Crown and ally of Douglas – Richard Prebble.

The community at large and financial markets and business people were keen to see whether the policies of Douglas – "Rogernomics" in New Zealand parlance – were to be maintained under Caygill's Budget. In the event this proved to be the case.

But the Budget announced on 27 July 1989 also proved to be precursor to another major political upheaval. In early August, Roger Douglas was reinstated to Cabinet by the decision of the Labour caucus – and it seems to the dislike of David Lange who resigned as Prime Minister and relinquished any Cabinet role. He has been succeeded by his deputy Geoffrey Palmer – also a lawyer and a former legal academic. He has allocated several duties to Mr. Douglas but they do not include a role in finance portfolios.

This political turmoil has been seen by many as a necessary settling down process. Both the political upheaval and the Budget itself must have the 1990 election in mind, but the former may be the more important of the two since, as will be shown, the Budget does not foreshadow any major fiscal changes, at least in the short term.

New Zealand is experiencing the usual honeymoon period for a new Prime Minister, whilst the verdict of the capital markets is likewise positive. Interest rates are falling, the stock-market has experienced a marked recovery in early August, whilst a substantial improvement in the balance of payments and a steadying in the rate of unemployment have all contributed to rising confidence. There seems to have been a lifting of the sense of malaise which has been only too evident in the last 2 years and the change is evidenced by a number of media articles seeking to analyze its causes as well as a recovery in poll ratings for the Government.

If a medical analogy is not out of place, New Zealand may be seen as having reached a crisis after its feverish place of change in economic direction and fiscal policy and to have pulled through the crisis with the fever now abating. For, paradoxically, the Budget – set in the context of momentous political changes over a few weeks – brings only relatively minor fiscal changes in its train, though it was the occasion for the announcement of major social policy changes.

II. BUDGET COMMENTARY

A. The year in retrospect

The Budget speech focused upon progress made in the last year highlighting:

- the fall in inflation – now at 4.4% to June 1989 – the lowest annual rate for 20 years;
- the fall in the current account deficit – now around 2% of GDP compared with 9% when the Government first took office in 1984;
- the deficit between Government revenue and expenditure – now at 1.5% of GDP compared with 7% in 1984;
- the fall in the burden of public debt – acknowledged still to be a problem but the official overseas debt has fallen from 41% to 27% of GDP;
- significant improvements in productivity – with examples cited in the energy and telecommunications areas. (Most commentators would agree that private sector productivity has also increased.)

B. Economic targets and economic growth

The Budget announced specific targets to be achieved by 31 December 1992:

- an annual inflation rate between 0% and 2%;

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- the reduction of public debt to below 50% of GDP – by a combination of public assets sales, State-owned enterprise loan repayments and fiscal surpluses;
- a reduction in first mortgage interest rates to between 7% and 10%;
- the reduction in the number of people unemployed to below 100,000 (currently about 170,000).

Whilst substantial economic growth remains the Government's prime objective, the Budget itself does not include expansionary measures. The Government is relying on continuing control over expenditure, sectoral reform of the waterfront, electricity, local government and local transport areas together with past measures and additional efforts to expand the benefits of international trade as providing the means to growth via greater competitiveness of New Zealand enterprises.

C. Social policy

The Budget speech contained a substantial review of the Government's social policy and reaffirmed its objectives in the areas of health, education and welfare spending – all within the context of fiscal restraint. These areas were singled out for attention.

1. Accident compensation

From April 1991, this scheme will cover disability, whatever the cause. This is a major change since disability from sickness will be covered. The emphasis will be on assistance for those with serious long-term disability. Whilst the average employer levy will fall from NZ$ 2.45 to $ 1.65 per $ 100 of leviable earnings, with effect from the 1990/91 tax year, there is some concern about the long run effects of the changes in employer levies following the major extensions to the scheme.

2. Benefit reform

A rationalization of the numerous types of social welfare benefits and the varying criteria for eligibility will be undertaken based on the concept of a generic benefit – to be known as the universal benefit.

3. National superannuation

This scheme, a hot political issue since its inception in 1975, provides Government retirement benefits at age 60. Some tax clawback effects operate when beneficiaries have income above threshold levels. The scheme is to be subject to some modifications both in the short and long term. Firstly, concessions are to be made from April 1990 to exclude 50% of certain other pensions and annuities from the surcharge (clawback) process – the rationale being that such pensions have an element of capital withdrawal of the taxpayer's original contributions.

Longer term changes include the slow dilution in relativity between national super and the universal benefit by means of a slowing down of cost of living increases. In addition, eligibility will, but not until the next century, be progressively adjusted until the age of entitlement rises to age 65. Demographic trends show that the proportion of the population aged over 60 will rise rapidly next century.

III. FISCAL CHANGES

A. General

Mr. Caygill's speech noted that the OECD had said recently that "the New Zealand tax system is now probably the least distorting in the OECD".

Major changes since 1984 have been:
- goods and services tax introduced (initially 10% but 12.5% from July 1989);
- fringe benefit tax introduced;
- a totally new set of accrual accounting rules for "financial arrangements" has been introduced;
- income tax rates and progressivity have been dramatically reduced;
- the concessionary treatments of farm livestock, superannuation and export revenue and expenditure have been removed;
- withholding tax has been imposed on resident interest and dividend income (similar to PAYE); and
- dividend imputation and a new international tax regime have been introduced.

The 1989 proposals can be seen as tidying up steps – "to remove remaining anomalies and distortions in the system" as the Budget speech states.

B. Land tax

Land tax is New Zealand's only annual wealth tax. (Estate duties do exist but do not provide significant revenue). It is thus a selective tax on a specific form of wealth and is levied at 2% on the Government valuation of land – with some exceptions. There has been continuing comment on the perceived inequity of this tax and in particular its impact on central business district properties in the main cities.

The changes to land tax are:
- The rate of tax in respect of land held at 31 March 1989 has been reduced to 1.5%. From 1990 on, the rate will be reduced further to 1%.
- The payment date will be shifted forward from October to May during 1990.
- Land used for farming, forestry, residential, charitable and recreational purposes will continue to be exempt, although a number of minor exemptions have been removed.
- The current exemption level for land tax will be reduced from NZ$ 175,000 to NZ$ 10,000.

These measures, which although reducing the rate of tax will significantly increase the tax base and the number of returns to be lodged by non-agricultural businesses. The yield is expected to increase for 2 years and then decrease thereafter.

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C. Timing of PAYE and withholding payment remittances

The Government proposes to accelerate its own cashflows and to reduce the working capital benefits to employers by reducing the average collection period from 5 to 2 weeks. This is to be achieved by making employers remit PAYE and superannuation contribution withholding tax payments twice monthly instead of once a month as hitherto.

This will have 2 effects – an increase in gross compliance costs and net compliance costs, because of the working effect noted above. This will not be popular, especially for firms with accounting systems structured around monthly reporting.

D. Excise duties

The Government is rationalizing the taxation of alcohol products by relating it directly to alcohol content. The new rates applicable from Budget night are: for beer and wine, $ 15 per litre of alcohol and for spirits, $ 30 per litre of alcohol. In order to provide more certainty to industry, the Government has also announced that it will in future index the rate of excise on beer and wine in accordance with movements in the consumer price index. There will be no automatic adjustment to the excise on spirits in recognition of its already higher rate.

The Government also intends to adopt a similar approach to excises on tobacco products. The initial rate will be levied at NZ$ 100 per kilogram of tobacco content. This excise will also be adjusted in accordance with movements in the consumer price index.

In March, the Government announced its intention to progressively reduce the specific tax on automatic diesel. This is one of the few selective taxes still remaining on inputs to production. This tax was reduced by 5 cents per litre in the Budget and duties on petrol and diesel will continue to be reviewed in the future.

E. Further tax reviews

The Government is currently examining potential tax reforms in 3 areas. A report from a working party on the taxation of charities and sports bodies favours the retention of the existing regime, but with some amendments to be made to counter both existing and potential abuses of tax-exempt status. Secondly, the taxation of petroleum mining activity continues to receive attention with legislation scheduled for introduction during 1989.

Finally, the major area of capital gains taxation remains to be addressed and the Government has announced its intention to publish a discussion document on this topic later this year.

IV. CONCLUSION

The New Zealand Government has gone to considerable lengths to publicise its Budget strategy and social policy initiatives and it is claiming it to be a "caring Budget". To the extent that it has had a substantial social policy content (evident from the separate Summary of Social Policy Announcements), with only minor fiscal changes, this claim has some validity. For once, a New Zealand Budget has resulted in only minimal changes to the New Zealand Income Tax Act 1976.

As the Budget edition of *New Zealand Current Taxation* points out:

> Mr. Caygill has presented a realistic budget which should go some way to satisfying both the welfare lobbyists and the business community. It continues the tradition of fiscal stringency and is further proof of the Government's commitment to achieving a balanced budget. At the same time, it contains very ambitious but attainable targets. However, given the budgetary stance, the Government must rely on a sustained lift in the economy to make any progress towards these targets, especially that of reducing unemployment.

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Some Highlights from the Secretary General's 1988/89 Annual Report

Presented at the Rio de Janeiro Congress 1989

J. Frans Spierdijk

AMSTERDAM CONGRESS

The 1988 IFA Congress was held in Amsterdam. This was the fifth time that the Dutch Branch hosted an IFA Congress (1939, 1947, 1955 and 1969) and 1988 was accepted for the Netherlands because it was the IFA's Jubilee Year, and the IFA's Invitations Subcommittee and Executive Committee felt it fitting to commemorate the first 50 years by meeting again in the Netherlands. The Congress was one of the largest IFA Congresses so far, with 1,477 participants and 731 accompanying persons from all over the world.

H.R.H. Prince Bernhard of the Netherlands assisted at the Opening Ceremony in the New Church in Amsterdam, on behalf of his daughter, Her Majesty Queen Beatrix, who could not be present owing to a State Function. The Secretary of State for Finance of the Netherlands, Mr. H.E. Koning, addressed the Congress, as did IFA's President, Mr. Richard M. Hammer, and the Chairman of the Dutch Branch and President of the 42nd Congress, Prof. A. Nooteboom.

At the 1988 Congress, IFA took leave of some of its Chief Officers. Prof. Dr. Jan H. Christiaanse, who had served the Association for almost 20 years, retired as Secretary General. Prof. Christiaanse was made Honorary Secretary General and an Honorary Member at this Congress.

Dr. Raoul Lenz of Switzerland, who served as Chairman of IFA's Permanent Scientific Committee since 1970 retired and was made an Honorary Member of the Association.

There were 4 other Honorary Memberships awarded in recognition of the work and commitment towards the Association, to the following persons: Prof. Narciso Amoras Rica, of Spain; Prof. Dr. R. Halpern of Austria, Prof. Sibille of Belgium; and Mr. P. den Boer of the Netherlands.

The General Assembly of the Amsterdam Congress officially approved, after recommendation by the General Council, the nominations of 2 Officers of the Association. As a successor to Dr. Raoul Lenz as Chairman of the Permanent Scientific Committee, Prof. Avv. Augusto Fantozzi of Italy was appointed. As successor to Prof. Dr. Jan H. Christiaanse, the undersigned was elected Secretary General.

Mr. Karl Beusch (Federal Republic of Germany) was unanimously nominated as President-Elect of the Association during the General Assembly to succeed Mr. Richard M. Hammer (U.S.A.) at the close of the 1989 Congress to be held in Rio de Janeiro.

The scientific side of the Congress was well attended. Subject I: "Recognition of Foreign Enterprises as Taxable Entities", provided some lively working sessions. The General Reporter of this Subject was Prof. Dr. K. van Raad (Netherlands). I had the honour to be Chairman of the Working Session, and the Discussion Leader was Dr. K. Vogel (Federal Republic of Germany). Mr. W. Mulder (Netherlands) was Secretary of the Subject, and the Panelists were Mr. F. Bueno (Brazil), Prof. J.P. LeGall (France), Mr. J. Libin (U.S.A.) and Dr. E. Lechner (Austria). The Chairman of the Resolutions Committee was Dr. W. Ryser (Switzerland) who was assisted by the members Mr. H. Birk (Canada), Mr. P. Hobbs (U.K.), Dr. J.C. Peirano Facio (Uruguay) and Prof. K.S. Tikka (Finland).

Subject II: "Tax Treatment of Computer Software", likewise provided a lively debate and exchange of views. The General Reporters were Messrs. J.B. Jones and R.N. Mattson (U.S.A.) and Dr. K. van der Heeden (Netherlands) was the Chairman of the Working Session.

Mr. D.G.H. Bowman (Canada) acted as Discussion Leader and Mrs. J. Stavast (Netherlands) as Secretary of the Subject. The Panelists were Mr. Se Won Chang (Republic of Korea), Mr. J. Gonzalez Bendiksen (Colombia), Prof. G. Grosskopf (Sweden) and Mr. M.O. Penney (U.K.). The Chairman of the Resolutions Committee was Dr. H.A. Kogels (Netherlands), and the members were Mr. J.L. de Gandt (France), Mr. R.A. Gelski (Australia), Mr. H. Lappen (Federal Republic of Germany) and Mr. R. Ruiz Ramirez (Mexico).

There were 4 Seminars held during the Amsterdam Congress. Seminar A, on "Data Processing in Taxation", was chaired by Dr. H. Sebiger (Federal Republic of Germany), and Co-Chairman was Mr. J.N. van Lunteren (Netherlands). Dr. J. Dechant (Federal Republic of Germany) acted as Secretary of the Seminar. The Panelists nominated to the Seminar were Mr. S.D. Desmond (U.S.A.), Mr. S. de Santiago Rosa

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(Brazil), Mr. G.C. Svensson (Sweden) and Prof. H. Kaneko (Japan), who unfortunately was prevented from attending at the last minute.

Seminar B, on "Tax Consequences of Pension Provisions for the Internationally Transferred Employee", was chaired by Mr. P. den Boer (Netherlands) assisted by Mr. W. Laurens (Netherlands) as Secretary. The Panelists were Mr. J.P. Klein (U.S.A.), Mr. S. Kobayashi (Japan), Dr. W.F. Rath (Federal Republic of Germany), Mr. D. Swaine (U.K.) and Dr. L.F. Teixeira Pinto (Brazil).

Seminar C, on "Recent Issues in Tax Conventions", was chaired by Mr. M.J. Ellis (Netherlands), whose panel comprised Mr. R.J. Couzin (Canada), Mr. A.W. Granwell (U.S.A.), Mr. J.L. de Gandt (France) and Mr. D. Lüthi (Switzerland).

Seminar D, on "Draft EC Directives on Parent-Subsidiary Mergers and Arbitration", was chaired by Mr. R. Baconnier (France), and the panel comprised Mr. J.F. Chown (U.K.), Mr. R. Goergen (EEC), Mr. A.W. der Kinderen (Netherlands), Dr. M. Pires (Portugal) and Mr. A. Willemsen (Federal Republic of Germany).

PERMANENT SCIENTIFIC COMMITTEE (PSC)

The Permanent Scientific Committee held its Spring meeting in February 1989 in Florence, upon the invitation of the Italian Branch. Fantozzi chaired the meeting which was his first in his new function as Chairman of the Permanent Scientific Committee.

Sadly, the PSC was informed that one of its previous members, Prof. J. Aguilar of Mexico, who served on that Committee from 1974 to 1981, passed away in January 1989. The Committee stood in silence of his memory.

In Florence 3 new full-fledged members of the Committee were welcomed and recognized: Prof. J.M. Rivier (Switzerland), Mr. J.S. Hausman (Canada) and Prof. S.O. Lodin (Sweden).

The Permanent Scientific Committee took stock of the procedural aspects of the scientific work of the Association, both as regards the Cahiers, and the preparatory work for the subjects and seminars of Congresses. In the Spring meeting following a Congress, an important part of the discussion was devoted to reviewing the proceedings of that Congress. Whilst it is realized that generally the scientific sessions are well organized and structured, the PSC discusses areas of dissatisfaction which may have been expressed by the IFA attendees.

As a result, the PSC concluded that an even better preparation could be ensured by assistance at briefing meetings, preparatory meetings, and seminars, of specially designated Permanent Scientific Committee members, and this procedure will be implemented. The recently instituted procedure for "Grant of Authorship" by National Reporters, will be maintained and enforced.

The Committee also discussed the final preparatory work for the 1989 Rio de Janeiro Congress. There were 29 National Reports received on Subject I "The Disregard of a Legal Entity", the General Reporter being Mr. Condorcet Pereira de Rezende (Brazil) and 23 National Reports received on Subject II "Administrative and Compliance Costs of Taxation" the General Reporter being Prof. C. Sandford (U.K.).

The Committee discussed the 1990 Stockholm Congress preparations. Subject I will be "Taxation of Cross Border Leasing" with Prof. G. Lindencrona (Sweden) and Mr. S. Tolstoy (Sweden) as General Reporters, and Subject II "International Mutual Assistance through exchange of Information" with Avv. B. Gangemi (Italy) as General Reporter. There will be 4 Seminars at the 1990 Congress.

Seminar A will treat the "Nordic Multilateral Tax Treaty" and will be chaired by Prof. N. Mattsson (Sweden); Seminar B will treat "Double Tax Treaties between Industrialized and Developing Countries – the OECD and U.N. Models – A Comparison" and will be chaired by Prof. L. Mutén (U.S.A.); Seminar C will treat "The Extension of Tax Sovereignty Especially in Connection with Emigration" and will be chaired by Prof. DDr. H.G. Ruppe (Austria); and Seminar D will treat "Tax Reforms in Scandinavia" and will be chaired by Prof. E. Andersson (Finland).

EXECUTIVE COMMITTEE

The Executive Committee met in Lisbon in May 1989 at the kind invitation of the Portuguese Branch, in conjunction with the Brazilian Branch who are hosting the 1989 Rio Congress.

Statutory retirements of Prof. A. Nooteboom (Netherlands), Mr. D.F.A. Davidson (U.K.), and Prof. Avv. P. Adonnino (Italy) as Members of the Executive Committee took place during the 1988 Amsterdam Congress Executive Committee meeting. Mr. Davidson remains a member of the Blueprint Committee.

Three new members of the Executive Committee were present at the May 1989 meeting: Mr. J.F. Avery-Jones (U.K.), Dr. K. Stocker (Switzerland), and Mr. A. Overbosch (Netherlands).

Mr. G. Delorme (France), Mr. F. Fernandez Ordonez (Spain) and Mr. A. Buelinckx (Belgium) were nominated by the Executive Committee to be 1st, 2nd and 3rd Vice Presidents of the Association, to take effect at the close of the Congress in Rio de Janeiro.

The IFA has Guidelines for the Organization of IFA Congresses which are sent to each of the hosting branches. The Executive Committee, in recognizing the improvements suggested for the scientific structure by the Permanent Scientific Committee, the suggestions made by the Blueprint Committee, and its own discussions, has instructed the IFA General Secretariat to re-issue these Guidelines in the form of a loose-leaf Policy Manual in the future to be called "Guidelines on How an IFA Congress should be Or-

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ganized". The IFA Administration is extremely fortunate that each annual Congress is prepared and organized in close cooperation with the Organizing Committees of each Hosting Branch, and feels that this will be greatly facilitated and enhanced to the benefit of the IFA Membership by an even better joint cooperation, with the use and enforcement of these Guidelines.

The Executive Committee discussed the report by the IFA Invitations Sub-committee on future annual congresses. The Invitations Sub-committee has submitted invitations to hold congresses from several IFA Branches, and amongst these are invitations from Italy, India, France and Canada for the near future.

BLUEPRINT COMMITTEE

In last year's Annual Report of the Secretary General, Prof. Christiaanse informed the IFA members about the installation of this Committee. Since that time, the Blueprint Committee has held 4 meetings, and at the May 1989 Lisbon Executive Committee its Charter was extended and its Terms of Reference defined. The composition of the membership of the Blueprint Committee was reconfirmed by the Executive Committee with the addition of new members from future congress organizing committees and the President-Elect.

The Blueprint Committee will continue to monitor the results obtained from the Mini Questionnaire distributed at the annual Congresses, with the specific purpose of passing on comments received from IFA Congress participants to the Permanent Scientific Committee and the Executive Committee.

The Mini Questionnaire distributed at the 1988 Amsterdam Congress did not provide a conclusive outcome of participants' opinions about a restructuring of the scientific programme, and this will be further pursued by the Blueprint Committee, again by way of the Mini Questionnaire. However, there was no doubt that the IFA participants want more variety in the congress scientific programme, and preferably by way of seminars, which could also be parallel. This demand is being met by the Permanent Scientific Committee, in cooperation with the Congress hosting branches, and the 1989 Rio de Janeiro Congress will offer the participant 5 Seminars in addition to the 2 main Subjects.

Also due regard to IFA participants' preferences regarding Congress dates, and information pertaining to their professional background, will be asked in the 1989 Mini Questionnaire, and more information regarding participants' observations on the scientific Congress structure will be asked in the 1990 Mini Questionnaire.

The Blueprint Committee is also discussing the impact of shortening IFA Congresses, unbundling some of its events, and optionalizing the excursions and moving them to the end of the week. In view of the ramifications involved, although the Executive Committee has in principle approved these proposals, they cannot be implemented until the early Nineties. This is because a congress of IFA's magnitude has to be organized several years in advance, and binding obligations have already been entered into by some hosting branches for future IFA Congresses.

In conjunction with the suggestion to study centralizing the organization of the annual IFA Congress, and the revision of the Guidelines on the organization of the IFA Congress by the IFA General Secretariat, the Secretariat has instituted a Central Data Bank on information fed back from the annual congresses by the Hosting Branches. This will provide valuable information to future congress organizers.

MEMBERSHIP FEES

The General Treasurer has had to propose an increase in the Membership fees for 1990. This proposal will be submitted to the General Council and General Assembly at the 1989 Congress.

The proposed fees for 1990 are:
105 Dfl. for individual members of National IFA Branches
115 Dfl. for direct individual members of IFA
250 Dfl. for corporate members, both direct and of National IFA Branches.

This membership fee increase as proposed by the General Treasurer takes into account the Executive Committee's and General Council's recommendations that the IFA working capital balance should not fall below 900,000 Dfl. In view of the removal of the headquarters and General Secretariat of the Association to modern offices in the World Trade Center in Rotterdam, the Netherlands, following the retirement of Professor Christiaanse last year, and allowance for a 75,000 Dfl. expense account for travelling which I expect to incur in the first year of my term as the new Secretary General, the General Treasurer was forced to propose this membership fee increase to bring the revenues and costs of the Association back into balance.

NATIONAL BRANCHES AND MEMBERSHIP

A new National Branch of the Association in Bermuda was recognized during the Amsterdam Congress. We welcome this new Branch and in particular one of IFA's long-standing active members, Mr. Ray Moore, who, after having been personally instrumental in the creation of the Hong Kong Branch, moved to Bermuda and galvanized a number of qualifying persons on the Island into joining the Association within a very short space of time. The Bermudian Branch is the 37th National IFA Branch.

We fear that the Caribbean area is no longer safe from the tentacles of IFA, since our current President, Mr. Richard M. Hammer, has already addressed the island of Barbados, and likewise, produced 40 people in-

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terested in forming a National Branch, and we understand that the Governor of Barbados has expressed his interest and support by attending one of its membership meetings.

The Nominations Committee hopes to recognize a Branch in Barbados at its 1989 Rio de Janeiro Congress. It would then become the 38th National Branch.

The Chairman of the Nominations Committee, Mr. A. Elvinger (Luxembourg) assisted by the Nominations Committee members: Mr. J. Sainz Alarcon (Mexico), Mr. S.H. Goldberg (U.S.A.) and Mr. T. Miyatake (Japan) have conscientiously performed their task of scrutiny of new applicants for membership, and draft constitutions of newly formed National Branches. The Executive Committee and General Council have accorded the Nominations Committee and its members the status of Standing Committee during the Amsterdam Congress.

The Nominations Committee recommended that 2 matters of a policy nature be submitted to the Executive Committee, which body ratified same. This concerned firstly the position of "Candidates for IFA Membership" who applied to join the Association, and whose applications are subject to the approval of their National Branches. A policy letter was sent out to the National Branch Secretariats clarifying that applicants could be treated as such by the Central IFA Administration, upon a written recommendation by the National Branch in the event that the National Branch's admission could only take place during a membership meeting, which may be later than the date of the candidate's application.

A second policy letter went to the National Branch Secretariats reminding them of the IFA Statutes governing the forms of membership. The Statutes are quite clear regarding individual membership of IFA Branches, and direct individual membership in countries where there is no National IFA Branch, and corporate membership.

REGIONAL CONFERENCES

After the success of the First Regional IFA Conference held in New Delhi, in February 1988, on the initiative of the Chairman of the Indian Branch, Mr. O.P. Vaish, I have pleasure in informing you that the Second Regional IFA Conference will be held in Hong Kong from 22-24 November 1989, under the Chairmanship of Mr. Ian W. Harris, Secretary of the Hong Kong Branch.

This Regional Conference will treat 3 major issues, pertinent to the Region, from which the anticipated attendance will derive. They are: Subject I, "Basic Law of Hong Kong"; Subject II, "Five Dragons" (tax policies of Korea, Taiwan, Hong Kong, Singapore and Thailand); and Subject III, "Multinational Enterprises" (a comparison between Japan and the People's Republic of China).

MITCHELL B. CARROLL PRIZE 1988

There were 4 entries for the Prize this year. After a thorough and difficult deliberation because of the standard of the entries submitted, the Jury, under the Chairmanship of Prof. DDr. H.G. Ruppe, came to the unanimous decision that the Mitchell B. Carroll Prize 1988 be awarded to Mr. Luc de Broe (Belgium) for his work in English, entitled "Tax and Accounting Aspects of Leasing under Belgian Law and the Belgium–U.S. Tax Treaty".

The composition of the Jury was amended somewhat following resignations. Prof. Ruppe remains as Chairman, and will continue to be assisted by Prof. I. Claeys Boúúaert (Belgium), Mr. H.M.A.L. Hamaekers (International Bureau of Fiscal Documentation, Netherlands), and in the future will be assisted by Prof. P. Adonnino (Italy) and Prof. H.G. Ault (U.S.A.).

The Executive Committee has approved a change in the rules of the Mitchell B. Carroll Prize. The date of entry for submission of works was advanced from 1 May to 1 April; the amount of the prize was increased from US$ 1,000 to US$ 1,500. The composition of the Jury will no longer be restricted to members of the Permanent Committee.

In an endeavour to attract more young fiscalists to enter for this prize, the Executive Committee is studying – in collaboration with the Jury members – the possible addition of a fourth language, Spanish. If at all possible, this will be implemented, but such a step is subject to finding qualified Jury members who are fluent in all 4 IFA languages, since the Jury is against delegation of readership.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The Bureau's Chief Executive, Mr. H.M.A.L. Hamaekers, and the undersigned are entering into talks for a closer collaboration regarding the publications of IFA's scientific works.

We have agreed that we will use our best efforts to jointly promote the IFA and the IBFD activities and publications. Following the retirement of Prof. Christiaanse as a member of the Bureau's Board of Trustees, I was invited and gladly accepted the position created by this vacancy. I attended the 29 May 1989 Annual General Meeting of the Board of Trustees.

THE 43RD CONGRESS OF IFA IN RIO DE JANEIRO

The organizing Committee of the 43rd Congress has been holding regular meetings over the past few years to ensure that all preparations for the Congress are proceeding smoothly.

The Brazilian Branch submitted an invitation to hold

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a congress in Brazil many years ago, and 1989 was the first year which could be allotted to them. The organizing Committee has been working to hold a congress up to standards of all our IFA Congresses, and we have no doubt that they will meet their goal. The Brazilian Branch's task has not been made easy by local circumstances in Rio but they have risen to the occasion splendidly and we can be sure that all who attend the Rio Congress will sample famous Brazilian hospitality and warmth, and will leave Brazil with good memories.

Let us take this opportunity to sample the unique sights, sounds and flavours of this city. We are going to participate in an exiting social programme, and sample one of the things for which Rio is famous – Samba!

We look forward to interesting scientific subjects to discuss, to more seminars, and to a very enjoyable Congress as a whole. We wish the Brazilians all success and are confident that their hard work will be more than rewarded by happy IFA participants.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

I should like to express thanks on behalf of the Association to the "Ambassadors", whose Reports are reproduced in the IFA Yearbook. This continues to provide a valuable survey of the work done by other international organizations in similar fields. They are: Mr. R. Baconnier (France), Prof. J.H. Christiaanse (Netherlands), Mr. J.H. Guttentag (U.S.A.), Mr. H.M.A.L. Hamaekers (IBFD) and Mr. Richard M. Hammer (U.S.A.).

International Fiscal Association

MITCHELL B. CARROLL PRIZE

The International Fiscal Association ("I.F.A.") offers a Monetary Award of US$ 1,500.– and a Medal and Certificate, to works devoted to international fiscal law, comparative tax law, or national tax law, having an important relation with fiscal law in foreign countries, to young persons under 35 years of age; which either have not been published at all or have not been published more than 2 years previous to submission.

Papers must be written in either English, French or German.

Winners are invited to attend IFA's Annual Congress during which the Prize will be awarded.

Further details obtainable from:

General Secretariat of IFA
World Trade Center
Beursplein 37,
P.O. Box 30215
3001 DE Rotterdam, Netherlands

Telephone: (010) 4052990
Telecopier: (010) 4055031
Telex: 23229 beurs nl, attn.ifa

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 50-52 of the January 1989 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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North Ryde, CCH Australia Limited, 1989.
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Sydney, Australian Tax Research Foundation, 1989.
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Takehiko Nakao:

Japan: Das Anrechnungssystem für ausländische Steuern: rezente Änderungen *506*
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Michael J. Andrew:

Australien: Ein Überblick der Vergünstigungen für Forschung und Entwicklung *511*
Dieser Artikel beschreibt die wichtigsten Merkmale der Methoden, die in Australien eingeführt wurden, um die industrielle Forschung und Entwicklung (R & D) zu fördern. Diese Methoden bestehen aus direkten finanziellen Subventionen und grosszügigen Steuerabschreibungen für R & D-Aufwendungen bezüglich Anlagen, Maschinen und Gebäuden, welche für R & D bestimmt sind.

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Edwin Vella:

Die Gesellschaftsfortsetzung im Rahmen des maltesischen Gesetzes von 1988 bezüglich internationaler geschäftlicher Aktivitäten *518*
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A.C. Ezejelue:

Nigeria: Der Haushalt 1989 und die Änderungen in den Steuergesetzen *522*
Das strukturelle Anpassungsprogramm („structural adjustment programme" oder SAP), das seit 1986 die Grundlage der nigerianischen Wirtschaftsstruktur bildet, besteht aus einer Anzahl von Zielsetzungen zur Wirtschaftsänderung, welche u.a. zum Zweck haben, die Effizienz des Verwaltungsapparates zu verbessern, die Ausgabenpolitik umzustrukturieren und finanzielle Disziplin einzuführen. Die Regierung hat im Haushalt 1989 eine Reihe von Massnahmen auf dem Gebiet der Steuern, der Währung und der Kreditpolitik ergriffen, um den Prozess der Konsolidierung der durch SAP erhaltenen Vorteile weiter zu führen. Dieser Artikel bespricht die wichtigsten Merkmale dieser Steueränderungen.

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CANADA:

The Section 482 White Paper

A Canadian Perspective

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This article is based on the text of a paper delivered by the author to a seminar sponsored by the World Trade Institute, "The White Paper on Section 482", Boston, 6-7 February 1989. Another version of this article appears in 41 *The Tax Executive* (Spring 1989) at 285.

I. OVERVIEW

For many observers, in Canada and other foreign countries as well as the United States, the enactment in 1986 of the super royalty rule appeared to revolutionize the manner in which cross-border intercompany transfers of manufacturing or marketing intangibles would be required to be priced for U.S. tax purposes.[1]

It seemed that the general (and often illusive) arm's length standard would no longer govern and U.S. licensors would generally be required to increase charges to foreign subsidiary licensees.

The authorities in high tax countries such as Canada have been particularly concerned that such increased charges would exceed those mandated by an arm's length standard. There were basically 3 reasons underlying such concerns. First, although super royalty was intended by Congress as another step towards countering unacceptable shifting of profit by U.S. companies to subsidiaries based in low or no tax havens such as Puerto Rico, the rule as enacted applies equally to transfers by U.S. companies to subsidiaries located in high tax countries such as Canada. Second, the 1986 reduction of U.S. corporate tax rates and restriction of foreign tax credits (by H.R. 3838) created an impetus for U.S. companies to maximize intercompany charges to subsidiaries in high tax countries. Third is the requirement, expressed in the legislative history to the enactment of super royalty, that where licenses of high value intangibles are involved, there is required an annual or other periodic assessment of the actual income earned by the group and a commensurate periodic adjustment of the payments actually being made (or if not made, to be reported for U.S. tax purposes) by the parties.[2]

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V. SUMMARY

1. Sec. 482 of the Internal Revenue Code of 1986 (the "Code"), as amended by Sec. 1231(d) of the Tax Reform Act, P.L. 99-514 (H.R. 3838), added the following requirement: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)-(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". A consequential and similar amendment was made to Sec. 367(2)(2)(A) of the Code. For a full discussion, see Robert T. Cole, "Working with the Section 482 White Paper", 41 *The Tax Executive*, No. 2 (Winter 1989) at 137, as well as articles and papers referred to in note 6.

2. Report by the Conference Committee of the Senate and House of Representatives, H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) at II-637-638 ("The Conference Committee Report"), in respect of the August 1986 agreement on H.R. 3838 and the Explanation of the initial version of H.R. 3838 Submitted by the House of Representatives, H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985), at 420-427 ("The House Report"). See also, the United States, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. (4 May 1987), at 1014ff. (Collectively, the "Staff Reports").

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The 1986 enactment left unclear how super royalty would apply and there was anxiously awaited an in-depth study which the Treasury was mandated to prepare by the Conference Committee of the Senate and House of Representatives on H.R. 3838, concerning intercompany arrangements in general and the manner in which super royalty would be applied in particular.[3] The study ("the White Paper") was released on 18 October 1988.[4]

The White Paper, which, inter alia, sets out detailed proposals respecting the substantive aspects of super royalty as well as proposals for administrative compliance policies and practices, should go a long way towards alleviating the initial concerns. The White Paper indicates that super royalty will not depart from the arm's length standard as applied in other countries such as Canada[5] and that it will not depart in any material fashion from the pre-1986 law in the United States. However, this view is not necessarily shared by all and, in particular, tax authorities in countries such as Canada continue to worry that super royalty will lead, inadvertently or otherwise, to excessive charges by U.S. companies to Canadian and other foreign subsidiaries.[6]

II. A BASIC LIMITATION IN TRANSFER PRICING RULES

There seems to be a contradiction between the nature of the problem posed by intercompany transactions and the way it is being dealt with by tax administrators. Intercompany pricing questions are ones of facts and circumstances and no single set of rules can provide a basis to measure and assess, in a technical or scientific and objective fashion, compliance with the objective of proper pricing between related parties.

All legislation, except in the case of Japan, recognizes this basic limitation and provides a briefly worded general rule mandating an arm's length price, which comprises no more than 4 or 5 lines of law.[7]

On the other hand, the tax administrators charged with enforcing compliance with the arm's length principle seek to establish detailed rules.[8] Tax administrators devote substantial energy attempting to establish a quasi-legal basis for the manner in which they consider a fair and reasonable price (which is the legal principle) is to be determined in any particular case, and in this sense the White Paper could be seen as nothing more than another variation on this theme. In the absence of true comparables (transactions of a largely identical nature, undertaken with unrelated parties) or arbitrary (apportionment formula) methods of dividing up income between related par-

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3. "The Conferees are also aware that many important and difficult issues under section 482 are left unresolved by this legislation. The Conferees believe that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect." The Conference Committee Report, at II-638.

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4. "A Study of Intercompany Pricing, Prepared by the Treasury Department's Officer of International Tax Counsel and Office of Tax Analysis, and Internal Revenue Service's Office of Assistant Commissioner (International) and Office of Associate Chief Counsel (International), Discussion Draft Released Oct. 18, 1988."

5. Canadian law on intercompany transactions is governed by the requirement that the price charged be reasonable in the circumstances. These rules are basically found in the briefly worded provision of Sec. 69(2) and (3) of the Income Tax Act, S.C. 1970-71-72, c.63, as amended ("the Act"). The Canadian approach is based on recommendations of the Organisation for Economic Co-operation and Development ["Transfer Pricing and Multinational Enterprises", Report of the OECD Committee on Fiscal Affairs, 1979 (Paris: OECD, 1979) as well as, to some extent, the OECD's "Transfer Pricing and Multinational Enterprises: Three Taxation Issues", Report of the OECD Committee on Fiscal Affairs, 1984 (Paris: OECD, 1984)] and is summarized in Revenue Canada's Information Circular 87-2, "International Transfer Pricing and Other International Transactions", 27 February 1987. For a detailed discussion of the Canadian rules and Information Circular 87-2, see Nathan Boidman, "Canada's Administrative Guidelines for Multinational Transactions: Information Circular No. 87-2", 40 *The Tax Executive*, No. 1 (Fall 1987) at 35; Nathan Boidman, "Transfer Pricing in Canada", 1987, Chapter in *The Tax Treatment of Transfer Pricing* (loose-leaf service published by the International Bureau of Fiscal Documentation, Amsterdam, The Netherlands); William D. Anderson, "A Potpourri Of Elements In Computing Business Income: Part 2", Corporate Management Tax Conference, 1987 – Current Developments In Measuring Business Income For Tax Purposes, Canadian Tax Foundation, at 6:1.

6. See, for example, John A. Calderwood (Director, International Audit Division, Revenue Canada, Taxation), "Pricing for Intangibles, Goods and Services under Super Royalty", Georgetown University Law Center Seminar, "International Conference on Section 482 White Paper: Pricing for Intangibles, Goods and Services under Super Royalty", Washington, D.C., 27-28 October 1988; Go Kawada (Director, Office of International Operations, National Tax Administration of Japan), "Comments on Section 482 White Paper", Georgetown University Law Center Seminar, supra, and John A. Calderwood, "International Transfer Pricing: Impact of the IRS Section 482 White Paper – A Perspective from Revenue Canada, Taxation", Report of Proceedings of the Fortieth Tax Conference, Canadian Tax Foundation, 1988 (not yet published). These criticisms have not been restricted to foreign tax authorities. See generally papers presented at the Georgetown University Law Center Seminar, supra, as well as James Fuller, "The IRS Section 482 White Paper", *Tax Notes,* (7 November 1988) at 655. For observers who view the White Paper more favorably, see Robert T. Cole, supra, note 1, and Robert T. Cole, "Observations on the Treasury/IRS White Paper entitled "'A Study of Intercompany Pricing' of October 18, 1988", Georgetown University Law Center Seminar, supra; Ian Hunter (Inland Revenue, United Kingdom), "Double Taxation: Dispute Resolutions Through Competent Authority", Georgetown University Law Center Seminar, supra; Robert J. Patrick, "A U.S. Practitioner's Perspective on the U.S. Internal Revenue Service Treasury Department Study of Pricing for Intangibles", Report of Proceedings of the Fortieth Tax Conference (1988), supra; and Nathan Boidman, "The U.S. Super Royalty Rule – A Canadian Perspective", Report of Proceedings of the Fortieth Tax conference (1988), supra. See also Stephen E. Shay, "Section 482 and the Super Royalty: The 1986 Tax Amendment, Prior Law and the Treasury White Paper of October 18, 1988", World Trade Institute Conference, "The White Paper on Section 482", 6-7 February Boston (and other papers presented at that conference).

7. For example, in Canada, Subsecs. 69(2) and (3) of the Act mandate a transfer price that is "reasonable in the circumstances", while Sec. 482 of the Code mandates reallocations "in order to prevent evasion of taxes or clearly to reflect the income" of any of the parties to the transaction. Furthermore, as noted above, super royalty is a simple one-sentence addition to the pre-existing one-sentence rule. The same pattern can be seen in most other countries which base their systems on the 1979 OECD Report (supra note 5). Only in Japan has the legislator attempted to go beyond the statement of the simple principle. See Art. 66(6) of Japan's Special Taxation Measures Law, effective for tax years beginning after April 1986, which sets out the basic arm's length principle as well as details, mainly tracking the 1979 OECD Report, as to its application.

8. This is seen in countries such as Canada (Information Circular 87-2), the United States (Sec. 482 Regulations), Federal Republic of Germany (1983 Administrative Guidelines), etc. See Nathan Boidman, "Canada–U.S. Intercompany (and Other) Taxation Issues", Report of Proceedings of the Thirty-Fifth Tax Conference, 1983, Canadian Tax Foundation, at 343 et seq.

ties, there is no objective basis upon which taxpayers' transactions can be tested. Taxpayers and tax administrators must subjectively evaluate the various factors which may be imputed as to how taxpayers would have acted with third parties, and if they fail to agree, the courts will impose their own (subjective) evaluation.[9]

Where comparables are not available, resort is then required to so-called secondary methods. In the case of integrated manufacturing and marketing operations, there is the retail sales method, where one company does the manufacturing and the other the marketing. Where both are involved in the manufacturing, there is the cost plus method. These "secondary" methods are often subjective and where they fail to provide an adequate solution, reliance must be had on "other" or "fourth" methods. (The White Paper rejects the priority of the secondary methods over the latter). Here there is a clear acknowledgment of the basic problem and, from a legal analysis standpoint, a reversion to the basic principle that, ultimately, the amount should be "reasonable" and it is a question of facts and circumstances which, of course, vary in each case. The U.S. Regulations on "fourth" or "other" methods are basically non-existent while Revenue Canada has sought to give a simple example of what might be a so-called "fourth" method.[10]

Legislators seem to accept that it is futile to try to systematize the general principle, and that its application is best left to the courts. Unless Government is prepared to change the nature of the rules and use mechanical (and necessarily arbitrary) apportionment formulae, finding a reasonable arm's length price in an intercompany transaction (where valid comparables are not available) is not amenable to a comprehensive objective process.[11]

It was noted earlier[12] that the IRS's own studies show that the majority of cases cannot be resolved by valid comparables which are the only truly objective standard by which the arm's length principle can be applied.

III. THE IRONY OF SUPER ROYALTY

For Canadian observers the genesis of the super royalty rule is ironic because of a fundamental difference between the tax systems of the 2 countries in relation to transfers of property to foreign affiliated corporations. From the Canadian perspective, the scheme of taxation under the Code concerning transfers of property to foreign corporations or "possessions corporations" had a built-in defect, allowing for a shift of profits to a foreign jurisdiction in a manner not consistent with a comprehensive taxation system which generally seeks to tax all income, particularly in obvious circumstances.

Under Canadian law a Canadian company which, through its own research and development, creates a valuable product cannot assign the related rights to a foreign subsidiary without being required to either recognize immediate taxable gain (upon an outright assignment) or take into income, over time, a stream of royalty type payments (upon a license of the rights). Upon an outright assignment, Sec. 69 of the Act requires that the rights to the product (i.e. the various intangibles, etc.) be valued, and are deemed sold at fair market value. The imprecise nature of valuations and the possibility that Revenue Canada will assign a much higher value than does the taxpayer comprises a substantial deterrent to actually proceeding with such an arrangement, even if the taxpayer is prepared, which he usually is not, to finance the upfront costs of the future tax savings.[13]

In the United States, however, before 1984 there was a substantial gap in the U.S. scheme of taxation relevant to the foregoing situation where the developer of the new product was a U.S. corporation. As was seen in the *Searle*[14] and *Eli Lilly*[15] cases, the Code contained

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9. That the issues are not amenable to objective evaluation is substantially borne out by statistics developed by the Internal Revenue Service (IRS). These data show that the factor to be given primacy in seeking to establish a reasonable price, i.e. "comparables", is more often than not unavailable. All agree (the IRS and the U.S. Treasury through its Regulations under Sec. 482, Revenue Canada through the Information Circular, 87-2, the 1979 OECD Report, etc.) that, where available, transactions with third parties which are comparable (and ideally entered into by the taxpayer under review itself) comprise the best standard against which an intercompany transaction by such taxpayer is to be evaluated. Moreover, in determining whether transactions are comparable, thus undermining the apparently simple objectivity of the comparable price approach. The White Paper (at 21 and 22) summarizes the various IRS studies as follows:

Report	Percentage of Cases in Which Various Sec. 482 Pricing Methods Were Used			
	CUP*	Resale	Cost Plus	Other
1973 Treas. Report	20	11	27	40
Conf. Bd. Report	28	13	23	36
Burns Report	24	14	30	32
General Accounting Office	15	14	26	47
1984 IRS Survey	41	7	7	45
1987 IRS Survey (overall)	32	8	24	36
1987 IRS Survey (tangible property)	31	18	37	14

* In this table "CUP" refers to "comparable uncontrolled price".

10. See para. 20 of Information Circular 87-2.

11. This basic factor was acknowledged by a senior representative of the U.K. Inland Revenue, Ian Hunter, at a recent conference, as follows: "I think another reason that the U.K. has never sought to introduce subordinate legislation to support the legislation relating to transfer pricing is the very one which has caused difficulty in the United States for the 482 regulations. The number of facts and circumstances to which transfer pricing legislation applies are so varied that it is difficult to go beyond the initial reference to an arm's length price to produce regulations which fit in all cases to which they apply." (Ian Hunter, "Foreign Rules for Goods and Intangibles – United Kingdom", presented at Georgetown University Law Center Seminar, supra note 6 at 3).
Furthermore, Mr. Hunter stated (at 4 of the same paper): "In short, we have no specific rules to deal with intangibles, but seek to deal with transfers of intangible rights very much by reference to the overall economic effect of that transfer. We would agree wholeheartedly with that part of the White Paper which points out that this is a very difficult thing to do."

12. See note 9.

13. Even the possibility that the tax arising under Sec. 69 would be deferred by claiming a reserve on the transfer of intangibles, to the extent governed by Sec. 14 of the Act under the decision in *Timagami Financial Services Limited v. The Queen,* 81 DTC 5064 (F.C.T.D.) and 82 DTC 6268 (F.C.A.), was considered sufficiently offensive to Revenue Canada that Canada's 1987 tax reform, Bill C-139, has eliminated reserves on or in respect of proceeds for Sec. 14.

14. *G.D. Searle and Co. v. Comm'r,* 88 T.C. 252, 376 (1987).

15. *Eli Lilly & Co. v. Comm'r,* 84 T.C. 996 (1985), rev'd in part, aff'd in part and remanded, Nos. 86-9211 and 86-3116 (7th Cir. 31 August 1988).

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no broad-based rule, comparable to Sec. 69 of the Act, which would deem a disposition at fair market value applicable to all transfers of property to a foreign affiliate. There ensued, therefore, the tax-free transfers to possessions corporations or controlled foreign corporations operating in tax haven environments.[16]

The transferee corporation in such an arrangement was often seen as simply serving as a physical contract manufacturer, assuming little risk or making little investment but yet emerging with the lion's share of the overall group profit from the manufacture and sale of the product. This was particularly vexatious to the IRS where (as in *Searle* and *Lilly*) the final product was sold through the U.S. parent company's distribution network. From an economic or business standpoint, it is rather clear that the transferee corporations emerged with a share of overall profit totally disproportionate to their input in the overall integrated operation.[17]

Although the U.S. Government began reacting, legislatively, to this defect in 1982, with the special measures for possessions corporations (Code Sec. 936(h)), and in 1984 with a rule of general application requiring recognition of royalty type payments over time where intangibles are transferred under Sec. 351 to a foreign corporation (Code Sec. 367(d)), nothing in the Code (even as amended by the super royalty rule) imposes the burden, arising in such circumstances in Canada under Sec. 69 of the Act, of a complete and total taxable disposition. It is probable that had Code Sec. 351 not applied to the transfers made in the *Lilly* and *Searle* cases (by reason of provisions such as Sec. 69), the threat of such substantial immediate taxation may have been a sufficient deterrent to prevent such transfers in the first place and the ensuing series of legislative responses (including super royalty).[18]

In summary of this point (apart from the fact that the problem seems to have been cured more by the enactment in 1984 of Sec. 367(d) than by super royalty)[19], it seems clear that issues confronting the U.S. Government in this area would not have arisen, in the first place, had the non-recognition provisions of Sec. 351 not extended, in any fashion whatever, to transfers to either foreign corporations or possessions corporations. It is for this reason that Canadians, having regard to the prohibitive effects of Sec. 69 of the Act, can conclude that the same type of problem has not and would not arise under Canadian law.

IV. ANALYSIS OF SUPER ROYALTY[20]

A. Overview

As suggested at the outset, it is perhaps ironic that super royalty, enacted as a response to perceived abuses of the U.S. tax system by U.S. based multinationals, is viewed by some, including Revenue Canada, as an instrument by which U.S. based multinationals may exacerbate a perceived preexisting predilection to overcharge Canadian subsidiaries in order to reduce excess foreign (Canadian) tax credits. The Canadian Government has long been concerned about this problem and as early as 1963 enacted legislation specifically aimed at U.S. based multinationals.[21] Revenue Canada now fears that the enactment of super royalty can provide a rationale for U.S. companies to increase charges to Canadian affiliates in order to reduce excess foreign taxes.[22] It would, indeed, be ironic if U.S. companies were to utilize the super royalty rule, enacted to reduce profit shifting of income out of the United States, to improperly shift income into the United States and out of Canada. However, in light of the pre-existing issue, it is not difficult to visualize the fears which Revenue Canada may have that the enactment of super royalty can provide a handy mechanism (and rationale) to further plunder the Canadian fisc through increased charges to Canadian affiliates.[23]

16. See Code Secs. 351, 367 and 936 and Rev. Proc. 63-10 and 68-23. Sec. 85 of the Act (the Canadian counterpart of Code Sec. 351) had an absolute bar against non-recognition transfers to corporations formed outside Canada. Sec. 85.1 allows such transfer of shares of foreign subsidiaries and other affiliates in some circumstances.

17. The views of Mr. Charles Triplett, prime author of the White Paper, as reported in "U.S. Defends Super Royalty as No Violation of Arm's Length", *International Tax Report* (September 1988) at 3, are of interest: "In Triplett's view, the IRS was asleep when it granted favorable rulings for the tax-free transfers of the intangible property associated with 'crown jewel' products of subsidiaries in Puerto Rico, Ireland and Singapore".

18. The White Paper (at pages 46-47) makes perfectly clear the reason for the amendment: "the primary difficulty addressed by the legislation was the selective transfer of high profit intangibles to tax havens. Because these intangibles are so often unique and are typically not licensed to unrelated parties, it is difficult, if not impossible, to find comparables from which an arm's length transfer price can be derived".

19. Had the transfers in *Lilly* and *Searle* taken place after the enactments of Code Sec. 936(h) in 1982 and Sec. 367(d) in 1984, the U.S. transferors would have been required to recognize, as income for U.S. tax purposes, an annual amount as a deemed royalty (but there would not have been a deemed realization in the year of transfer). In this context and in light of the latitude provided the courts by preexisting Sec. 482 and the Regulations made thereunder to allocate income in accordance with the true contributions of the partners, as reflected, as least in part, in *E.I. DuPont de Nemours & Co. v. United States,* 608 F.2d 445 (Ct. Cl. 1979) and *Hospital Corporation of America v. Comm'r,* 81 T.C. 520 (1983), as well as *Lilly* and *Searle,* the add-on of the super royalty rule seems superfluous. (The necessarily subjective nature of such allocation can of course lead to disagreement between the taxpayer and the IRS respecting the decisions of the courts and, for example, the IRS (in the White Paper at page 30, et seq.) is quite critical of the decision in *Hospital Corporation of America* which allocated as much as 25% of the income to the offshore company. However, there does not seem to be any specific reason to believe that a court would necessarily come to a different factual determination in *Hospital Corportion of America* under super royalty).

20. A full analysis of the White Paper is beyond the scope of this article (see note 1).

21. Sec. 212(1)(a) of the Act was added, requiring a 25% tax on management and administration fees paid by a Canadian subsidiary to a foreign related company in specified circumstances. Ironically, the 1980 Canada–U.S. Income Tax Convention exempts U.S. companies from this tax.

22. Excess foreign (Canadian) tax credits may arise because of (1) tax rate differentials; (2) the Code "separate basket" rules; or (3) the interest allocation rules. With respect to (1), after tax reform in the 2 countries, the average overall Canadian rates (including withholding taxes on dividends) may be in the area of 43% for manufacturing profits and 48% for other profits. The standard U.S. federal corporate rate of tax is now 34%, leading to a potential excess foreign tax credit position of 9% in the former case and 14% in the latter case.

23. Revenue Canada is also concerned that U.S. based multinationals might have incentive to increase charges to Canadian subsidiaries merely ". . . in an attempt to ensure that they have complied with your legislation to the detriment of the other taxing jurisdictions". (Calderwood, Georgetown University Law Center Seminar, supra note 6, at 13).

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B. Consistency with the arm's length principle in Canada and elsewhere?

1. Overview

In principle, super royalty, as interpreted by the White Paper, seems to be nothing more than a codification of pre-1986 jurisprudential principles augmented by a more systematic approach to pricing methods where the objective standard of the "comparable uncontrolled price" is not available. To this extent super royalty raises an issue of form not substance in the international context and does not give rise to conflicts with the tax law governing intercompany transactions in Canada or other countries.

The White Paper states that super royalty is not to depart from the arm's length standard (as understood internationally and presumably therefore in Canada): "the chapter concludes that the arm's length standard is the accepted international norm for making transfer pricing adjustments. The study reaffirms that Congress intended the commensurate with income standard to be consistent with the arm's length standard, and that it will be so interpreted and applied by the Internal Revenue Service and the Treasury Department".[24]

There is, however, a disquieting aspect of the White Paper's view of super royalty in relation to competent authority cases:[25]

> The Service and Treasury recognize that implementation of the commensurate with income standard in all its particulars, including periodic adjustments, treatment of lump sum payments and access to information to perform the necessary analysis, may lead to differences with the competent authorities of our treaty partner and perhaps more general issues of treaty policy and interpretation. Recognizing this, the United States competent authority and the Treasury Department should be receptive to the concerns of foreign governments, and endeavor to seek bilateral solutions insofar as those concerns can be accommodated in a manner consistent with the Congressional intent in enacting the commensurate with income standard.

Is this to be interpreted as suggesting any restriction on competent authority procedure to resolve transfer pricing disputes?

In general, the reviews of the White Paper have been mixed and clearly not all observers share the views expressed herein.[26]

2. Comparables retained as priority standard

Comparable uncontrolled prices remain, under super royalty, the primary standard, in preference to any other method of determining an arm's length price. The White Paper distinguishes between comparables which are "exact" and those which are "inexact". In the former case, there is no basis for periodic adjustment while in the latter case the requirement for periodic adjustment seems to entail a rebuttable presumption that related parties would provide for modification of their arrangements, over time, as facts and circumstances change.

This is not inconsistent with the general notion of an arm's length standard, or the Canadian rules,[27] and this approach does not detract from the problem discussed earlier that the majority of cases are not in fact governed by comparables nor the problem noted in the U.S. cases, discussed in Chapter 4 of the White Paper, that the courts are inconsistent in their views as to comparability in varying fact patterns.[28]

The White Paper's position on comparables may be summarized as follows:
(1) Where a transaction with a related party can be tested against "exact" comparables, those would govern to the exclusion of any other pricing method and there would be no periodic adjustments (as discussed below).
(2) An "exact" comparable can only involve a transaction in the same intangible, licensed by one of the parties to an unrelated party.
(3) The standards for determining whether comparables are "exact" turn on "external" factors (i.e. with respect to the business and economic environment in which the comparable licenses take place) as well as

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24. See White Paper at 3. Although skeptics may dismiss this type of language in the White Paper as mere rhetoric, at least one U.S. observer believes that this language will create a legally self-fulfilling prophecy. See Fuller, supra note 6, at 660: "The White Paper states that Congress intended no departure from the arm's length standard in that the Tax Reform Act amendment is simply a clarification of the prior law. Since the courts have categorically rejected contract manufacturing and the use of industry statistics, presumably they will continue to do so, since the standard under the White Paper is arm's length, i.e. the same standard under which the courts operated in deciding in prior cases".

25. See White Paper at 61-62.

26. As noted elsewhere herein, Canadian and Japanese Government officials are quite critical. John Calderwood, in his paper to the Canadian Tax Foundation, supra note 6, stated at 34: "The Department sees the super royalty as a significant departure from the historical arm's length approach taken by the U.S. government in such matters. In attempting to widen its tax net the U.S. will be putting itself out of line and perhaps at odds with its largest trading partners".
Other observers are more generous. Robert T. Cole, a former International Tax Counsel (ITC) to the U.S. Treasury, at a conference held in October (Georgetown University Law Center Seminar, supra note 6), stated at 7: "As a matter of principle, I do not think that any of the rules enunciated in the White Paper depart from arm's length standard and, therefore, rather than reject the rules before the ink is dry because they might conceivably work to a country's disadvantage in the short run, I urge that they be given fair consideration and a fair trial".
Robert Patrick, another former ITC, in a paper to the Canadian Tax Foundation, supra note 6, noted the fears of critics that "the study foreshadows an arbitrary attempt to impose a new economic concept and unrealistic compliance requirements ..: based on the assumption that there is a precision to establishing the 'right' price". He was, however, of the view that "the study will be accepted as a contribution to rationalizing the fourth method under U.S. tax regulations ... and will require more systematic justification of pricing methods".
See also Ian Hunter, a senior representative of the U.K. Inland Revenue, supra notes 6 and 10, who indicated, at 1 and 2, some empathy with, but more importantly some understanding of, the approach of the White Paper and its role in dealing with international disputes under arm's length principles.

27. John Calderwood, Canadian Tax Foundation, supra note 6, expresses agreement (at 19) with the White Paper's delineation between exact and inexact comparables, and the ambit thereof.

28. For a discussion of Revenue Canada's views as to the standards for comparability, see para. 14 of the Information Circular, supra note 5. See the decision in *Indalex*, infra note 34, for an example of how Canadian courts view comparability.

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"internal" standards (i.e. the terms of the contractual arrangements between the parties).

(4) Not inconsistent with the problem noted elsewhere, that courts often cannot agree as to whether things are comparable or not, the White Paper goes on to state that:

> No amount of general discussion of these standards (i.e. the 'internal' and 'external' standards) is likely to turn them into objective tests. As in all matters concerning transfer pricing, facts and circumstances must determine the outcome of specific cases.[29]

(5) Inexact comparables are transactions involving similar although not identical intangibles.[30] In some circumstances "other" or "fourth" methods may be relevant where only inexact (not exact) comparables are available.

The foregoing may be compared to Revenue Canada's approach as set out in the Information Circular at para. 14: "Application of the comparable, uncontrolled price method tends to be restricted by the difficulty in establishing that the product involved, the market, the credit terms, reliability of supply and other pertinent circumstances are indeed comparable. The Department believes that if the comparable uncontrolled price method is to be used, variations in the respective circumstances should be minor or capable of quantification on some reasonable basis".

The use of fourth methods to support inexact comparables is consistent with para. 19 of the Information Circular: "Other methods may be employed in support of one of the three aforementioned methods or in circumstances where none of these methods is appropriate". (underscore added)

Revenue Canada clearly shares the White Paper's view that the use of inexact comparables is acceptable only if differences can be reflected by a reasonable number of adjustments (see para. 14 of the Circular, above).

3. Other methods where comparables are not available

In the absence of comparables, the arm's length standard can only be applied on the basis of either relatively subjective evaluations (secondary or other (fourth) methods)[31] or arbitrary formula approaches, neither of which meet the objectivity desired by the arm's length standard. The White Paper opts for fourth methods, consistent with the international norm and the approach in Canada, and attempts to formulate an analytical framework on which such determinations can be elevated to a quasi-objective process.

The White Paper's principal proposal is the "arm's length return method", which is intended to simulate the market place and result in a price to reflect how the parties may have dealt had they been unrelated.

The arm's length return approach seeks "to identify the assets and other factors of production that will be used by the related parties in the relevant line of business and would try to assign market returns to them".[32]

The methodology (made up of the "basic arm's length return method" and the "profit split addition" would be as follows:[33]

(1) Prepare a functional analysis, i.e. break down each line of business into its component activities or functions.
(2) Identify which of the functions utilizes only factors of production which can be measured and assigned market returns.
(3) Distinguish between those functions that make significant use of pre-existing intangible assets (usually of or by transferor) and those that do not (usually by transferee).
(4) Start off by assigning values to the transferee's factors of production because that is usually easier than assigning to the transferee value for the intangible.
(5) Assign income to each of the functions' measurable factors, i.e. "the functions that employ measurable factors will probably be carried on by a wide range of unrelated parties for which information will probably be available regarding market returns earned by them".
(6) After identifying returns for the transferee's functions, the residual income is then allocated to the transferee – which obviously will receive the lion's share in potentially high profit situations.
(7) If, however, both parties have valuable intangibles, the residual income must be allocated by a profit split.
(8) Do not allocate income for functions related to selling goods to a related party.
(9) To assign returns to the parties, the White Paper suggests 2 methods:
   (a) identify unrelated parties' rates of return on assets utilized in a particular function, taking into account only the non-liquid assets relative to the function for the line of business being examined (this assumes such information is available); and
   (b) measure arm's length information against a yardstick other than rates of return on assets: for example, the ratio of income to operating costs seen in *DuPont*[34], useful in measuring returns on service activity or in situations where assets are difficult to measure consistently or where there is reason to believe that the relationship and costs are more stable or easier to measure than the relationship between income and assets.

"The use of both types of unrelated party information is consistent with the fundamental goal of the basic arm's length return method, which is to use information about unrelated parties to determine the returns that

29. See White Paper at 88.
30. Although not dealt with specifically in the White Paper, one assumes that an "inexact" comparable can also include a license involving the same intangibles under consideration but in circumstances which do not meet the standards for an "exact" comparable.
31. As noted elsewhere, the White Paper questions the priority of the secondary resale or cost plus methods; in any event, these are basically inapplicable to transfers involving intangibles.
32. See White Paper at 95. 33. See White Paper at 96 et seq.
33. See White Paper at 96 et seq.
34. See note 19.

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would have been earned had the related parties' activities been undertaken at arm's length."[35]

(10)Where both parties have intangibles, a distinction should be made between "routine" intangibles and those which are unique or have major importance to the enterprise and which few unrelated parties possess. When more than one affiliate has these type of intangibles (i.e. excluding the case of the pure contract manufacturer affiliate, such as in *Lilly* or *Searle*), and identified in the White Paper as situations involving mature and complex onshore (e.g. European) affiliates, a profit split is required to reflect the return to each party with the valuable intangibles.

(11)A "profit split" essentially is a judgment call.

Even without the resemblance to the key elements of the pricing rationale considered or adopted in prior cases in the United States (or considered in Canada in *Indalex*[36], a case involving an offshore subsidiary interposed to transship the purchase of raw materials), it is clear that the method constitutes an approach to "other" or "fourth" pricing methods, necessary where comparables do not govern. An introductory comment in the White Paper foreshadows the required use of fourth methods as well as the U.S. Government's desire to systematize same to the extent possible:

> In practice, taxpayers and agents rely upon comparable uncontrolled prices or transactions, when they exist. When they do not exist, agents or taxpayers use whatever method they believe best reflects the economic realities of the transaction at issue.[37]

The fourth methods recommended by the White Paper (the basic arm's length return method and the profit split addition) seem to have been used by U.S. courts in *Lilly, Searle* and *DuPont.*[38] DuPont also used the test of the ratio of gross income to total operating costs as a test of the appropriateness of the income split between the U.S. manufacturer and its Swiss distribution subsidiary. The return on capital analysis in *DuPont* was considered by the Federal Court in *Indalex. DuPont* rejected as inappropriate gross margin analysis (and therefore the retail method).

The consistency of the arm's length return method and the Canadian approach to fourth methods should be evaluated in light of the stated purpose of the super royalty rule:[39]

> The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible.

To make such determination and arrive at an appropriate transfer price, there is to be an assessment of the functions performed, the economic costs incurred and the risks assumed by the parties. The objective is to assign income commensurate with the relative economic contribution of each party and the relative risks taken by each party. There seems to be no inconsistency between such a rule or philosophy and the arm's length standard as understood in Canada or other countries which rely on the 1979 OECD Report.[40]

This method is stated to apply regardless of the form of the transfer – outright sale, license, sale of tangible property which incorporates valuable intangibles or the transfer of intangibles through the provision of services.

Paras. 11 and 12 of Revenue Canada's Circular deal with the approach to be taken where intercompany arrangements cannot be based on transactions which would arise in the usual course of events between third parties. The idea, not inconsistent with the White

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35. White Paper at 98.

36. *Indalex Limited v. the Queen,* 86 DTC 6039 (F.C.T.D.) and 88 DTC 6053 (F.C.A.). See Nathan Boidman, "The Canadian Approach to Offshore International Transactions: Indalex v. The Queen – A Transshipment Case", 39 *The Tax Executive,* No. 1 (Fall 1986) at 45; and Nathan Boidman, "The Canadian Approach to Offshore International Transactions: An Update", 40 *The Tax Executive,* No. 3 (Spring 1988) at 383.
In other Canadian offshore transshipment cases (*Dominion Bridge Co. Ltd. v. The Queen,* 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.), *Spur Oil Ltd. v. The Queen,* 80 DTC 6105 (F.C.T.D.) and 81 DTC 5168 (F.C.A.) and *Irving Oil Limited v. The Queen,* 88 DTC 6138 (F.C.T.D.), this approach was not necessary: in *Dominion Bridge,* the matter was resolved on the basis that the offshore purchasing company was an agent and therefore all of its profit belonged to the taxpayer. In *Spur Oil* (discussed in detail in Boidman, 39 *The Tax Executive,* No. 1, supra) and *Irving Oil,* the case was considered by the courts to be governed by comparables without the need to look further. See Nathan Boidman, "Intercompany Pricing – Irving Oil Case", 17 *Tax Management International Journal,* No. 6 (June 1988) at 241.

37. White Paper at 23.

38. This is certainly borne out by the following excerpt from the White Paper which indicates a mere codification of case law: "Although some of the terminology in this section may be new, most of the techniques discussed in it are not. One of the main arguments for the development of an arm's length return method, in fact, is that taxpayers, the Service and especially the courts have found it necessary to use ad hoc and incompletely developed versions of such a method in the past and will undoubtedly continue to do so in the future. Therefore, the goal of this discussion is to lay a foundation for this approach so that it may be used to achieve more consistent and satisfactory results" (at 94).
There certainly is nothing radical about super royalty, interpreted in this fashion.

39. White Paper at 47.

40. Revenue Canada, however, has expressed strong reservations. Their general assessment of the arm's length return method, expressed by Mr. John Calderwood, Canadian Tax Foundation, supra note 6, at 20 is that it (the basic arm's length return method without profit length for valuable intangibles of each party to the contract) "would seem to have more application to tax havens and possessions situations" (at p. 20). With respect to profit split addition, where both parties do have valuable intangibles, Mr. Calderwood states (at p. 21): "Profit split methods are considered a last resort method. Unless it is part of the contract between the parties, it is a most difficult determination to make".
Moreover, Mr. Calderwood states at 32-33:
"With respect to commensurate with income, the White Paper stresses functional analysis as a basis for adjustments. The OECD does not appear to give it such prominence; it is one of many techniques used to establish the facts. While it is necessary to make a functional analysis in establishing the facts, there are no comments on how it will be used to calculate and determine the ratios for sharing the income from the use of intangibles. Functional analysis works well where tax haven situations exist, i.e. no functions are performed there, and possibly for possessions corporations, a concept which Canadian tax law does not have. However, for the genuine, viable subsidiary company using parent company technology, of which there are many in Canada, there may be problems for the competent authorities in valuing the intangibles and determining the appropriate charges".
This view does not seem to be consistent with the Department's own Information Circular. As well, Mr. Calderwood expresses concern, at page 13, that Canadian courts "have not handled sufficient cases to determine a consistent or predictable methodology", in respect of fourth methods and that "profit splits should be used as a last resort".

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Paper, is to establish a subjective but analytical approach to intercompany arrangements where comparables do not govern. In such circumstance, para. 11 advocates:

> .... a thorough functional analysis of the activities and contributions of each group member, and should clarify and quantify the various factors which were considered in establishing the transfer prices, e.g. technical assistance, access to technology, reward for economic risk, financing assistance, etc.

Para. 12 goes on:

> The quantum of income taxed in Canada should be consistent with the real profit contribution of the Canadian taxpayers involved, based on the economic functions performed and the risks assumed by them. This result is achieved when non-arm's length transactions with non-residents are consistently made at reasonable arm's length prices. The determination of reasonable arm's length prices, while necessarily somewhat subjective, is nevertheless a question of fact, and therefore the situation of each taxpayer must be examined on its own particular circumstances and merits.

Both of the foregoing paragraphs, appearing in the introductory portion of the Circular, are intended to govern any type of transfer in respect of any type of things. Furthermore, para. 15, which deals with the transfer of goods, establishes the fundamental nature of the analysis, regardless of the type of transaction[41], required where comparables are not available:

> Where appropriate comparables are not available and the taxpayer must use one of the other methods discussed in the following paragraphs, it is recommended that a thorough functional analysis of the activities of the group members be carried out (as mentioned in 11 above). A functional analysis will identify and evaluate, with respect to a given product or product line, the role and contribution of each member, including the economic risk assumed and the degree of responsibility for engineering and production, continuing research, management and administration, marketing and customer services. A functional analysis will facilitate informed decisions as to what constitutes an 'appropriate' mark-up or a 'reasonable' profit contribution, and it will help to identify severe distortions in the margins of related parties.

Although para. 45 of the Circular indicates that a royalty rate for a license where comparables are not available is to be determined by drawing

> comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions and similar licensing arrangements,

para. 47 effectively incorporates the approach advocated in para. 15, above, where it states:

> In the same way that a taxpayer is expected to explain the basis for the intercompany pricing policy when questioned by the Department, the taxpayer should also be prepared to demonstrate the reasonableness of intercompany royalties, having regard to all of the pertinent facts and circumstances.

Although briefly stated, the principles advocated by Revenue Canada do not conflict with the White Paper proposals and, to that extent, the super royalty legislation is consistent with the Canadian approach.[42]

The White Paper's analysis of the arm's length return method is focussed on the issues which have faced the IRS (the possessions corporation manufacturing arms in *Lilly* and *Searle, and the offshore marketing arms in DuPont* and *Hospital Corporation of America)*. It is not surprising that the White Paper does not relate the approach to the above noted type of issue seen in the Canadian case law involving offshore companies interposed to import goods (e.g. *Dominion Bridge, Spur Oil, Irving Oil* and *Indalex*); this is simply because this type of case has not preoccupied the IRS and certainly has not come before the American courts. As already noted, Revenue Canada relied upon elements of the IRS's approach in litigating *Indalex*. Similar arguments were raised in *Irving Oil* but were rejected because the Federal Court held that the issue was governed by comparable uncontrolled prices, which render inapplicable fourth methods, such as the arm's length return method discussed in the White Paper.

In summary, the arm's length return method does not seem to be inconsistent with the arm's length principle as understood and applied in Canada and other countries which base their intercompany pricing rules on the OECD guidelines.

4. The periodic adjustment rule

Undoubtedly the most vexatious and controversial aspect of the super royalty rule is the requirement that the proper measure of intercompany charges related to the transfer of unique high value intangibles requires an annual or other periodic assessment of the actual income earned by the group as a whole in order to arrive at a proper apportionment of income. This entails a periodic adjustment of the payments actually being made (or if not made, to be reported for U.S. tax purposes) by the transferee to the transferor.[43] However, the White Paper's explanation of this requirement may dissolve this issue and provide the basis for reconciliation with the law in Canada and other countries.[44]

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41. An introductory paragraph (No. 13) of the section of the Circular dealing with the transfer of goods stipulates that the principles discussed therein "... apply to the acquisition or disposition of intangible property as, for example, the outright transfer of ownership of a patent".

42. With respect to para. 45 of the Circular, there was an interesting exchange between John Calderwood, the Revenue Canada, and Charles Triplett, of the IRS, at a 27-28 June 1988 Seminar sponsored by the International Tax Institute, "The Competent Authorities from Six Nations Discuss Transfer Price Issues Amidst Changing Tax Rates and Fluctuating Currency Values". According to a summary in the *International Tax Report,* "U.S. defends super royalty as no violation of arm's length" (September 1988) at 3, Mr. Triplett was quoted as stating that he disagrees with para. 45 of the Circular in that it does not recognize the impracticality of seeking to effectively use inexact comparables for unique high value intangibles where there are no comparables at all. According to the report, Mr. Calderwood rebutted that the IRS had made no mention of this "crown jewel" problem when it reviewed earlier drafts of the Department's circular.

43. See note 2 and related text.

44. John Calderwood voices Revenue Canada's basic concerns about the periodic adjustment rule as follows (Canadian Tax Foundation, supra note 6, at p. 33-34):
"The periodic adjustment concept likewise poses questions. Will this be on an annual self-assessing basis or by an audit basis? It is difficult to accept that this "hindsight" basis is what persons dealing at arm's length would

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Periodic adjustment will not be required where the license may be tested by exact comparables, although there is some inconsistency between the text of the White Paper and its Example No. 1.[45] In other cases (particularly involving inexact comparables), the requirement for periodic adjustment seems to have the character of a rebuttable presumption, and it reflects the view of the IRS that where unique intangibles are involved, providing for periodic change of the division of income is the manner in which related parties would have contracted.

Taxpayers will have the burden of showing the contrary to the IRS or a court that the unrelated parties, in the circumstances under review, would not have provided for such a periodic adjustment. Although the suggested burden is high[46], the effect, in principle, is no different than the process in Canada, where Revenue Canada can assume facts (including an assumption as to whether or not unrelated parties would have provided for a review or renegotiation of the terms of a contract), with the taxpayer then having the burden of proving the contrary.[47]

The White Paper clearly establishes a less onerous rule than did the original legislation. In particular, nowhere in the House of Representatives' explanation of the super royalty, proposed in late 1985, or in the explanation of the final legislation by the Conference Committee was it indicated that the rule would take the form of a rebuttable presumption.

There is a general view that the periodic adjustment requirement overrides the decision in *R.T. French v. Comm'r*[48], which, according to the White Paper "endorsed the view that a long-term, fixed rate royalty agreement could not be adjusted under section 482 based on subsequent events that were not known to the parties at the original contract date".[49] Although the White Paper states that super royalty "is in part a legislative rejection of *French*[50] it would seem the actual nature of the proposal can be reconciled with that decision.

The White Paper asserts[51] that there is much evidence of arm's length pricing agreements which do provide for adjustments of royalty rates and payments under the agreement based on subsequent events, particularly if the profitability of the intangible is significantly higher, although unanticipated. This is strictly a question of fact: is there any reason to believe that proof thereof would not allow a court to distinguish the facts of the French case, and the surrounding evidence of comparable licensing arrangements? Although the White Paper does state[52] that it is

> .... perfectly consistent with the arm's length standard to treat related party license agreements generally as renegotiable arrangements and to require periodic adjustments to the transfer price to reflect substantial changes in the income stream attributable to the intangible[53],

as already noted, the paper goes on to confirm that where exact comparables exist or evidence is made to the contrary, periodic adjustment would not be required. It is stated:

> If a particular taxpayer demonstrates that it has comparable long-term, non-renegotiable contractual arrangements with third parties, the arm's length standard will preclude periodic adjustments of the related person intangible transfer price. In that event, a comparable

do. Where the use of high profit potential intangibles is involved, we suggest arm's length parties would determine a price at the particular time the use of the intangibles commenced. Also while any royalty rate might initially be for a short duration, provision would be made for subsequent, not annual, renegotiation. As representatives from the private sector have pointed out, renegotiation clauses are frequent for downward rate adjustments but rare for increases. While there are occasional examples of third parties obtaining rights or properties (in this context not always intangible property) at bargain prices, the more frequent situation is third parties paying too much for the property. Revenue Canada Taxation submits that it is only in extreme situations that third parties renegotiate for a reduced consideration, seldom, if ever, an increased consideration.
Specifically, with respect to the super royalty provision, the IRS, through hindsight, will be making adjustments to royalty rate percentages charged to related Canadian companies based on the profits realized by these Canadian companies not only from the use of the underlying technology but also as a result of the Canadian company's own efforts and initiatives. Furthermore, these adjustments may vary from year to year dependent upon the profits earned in Canada. The super-royalty provisions which generally apply for tax years beginning after December 31, 1986, seek to include in the U.S. company's taxable income amounts as payments from related Canadian and other foreign companies, commensurate with the income attributable to the transferred (licensed) intangible properties. This amount may be greater than an arm's length royalty, the excess amount being classified as the super-royalty".

45. See Jon Bischel, "The Treasury White Paper Commensurate With Income Standard and Analysis", at the Georgetown Conference, supra note 6, at 6 of his paper dealing with Example 1: "The conclusion of the foregoing example is somewhat at variance with the study which indicates that year by year equality is not essential if it is reasonable to conclude that the long term results would be comparable. Hence, the size and markets and royalty payments may annually vary without destroying exact comparability".

46. Bob Patrick in his paper delivered to the Canadian Tax Foundation's annual conference, supra note 6, notes that "while the study states that the taxpayer may rebut the use of subsequent experience, the required burden of showing that unrelated parties would not have provided for adjustments in cases of inexact comparables appears too difficult to me". Michael Abrutyn, "Administrative Requirements – A Look Ahead", Georgetown Conference, supra note 6, states at 8: "It is also suggested that the taxpayer has the burden of proof by "clear and convincing" evidence (of civil fraud standard) to demonstrate that subsequent profitability cannot have been anticipated. This could prove to be an almost impossible burden for a taxpayer to satisfy because of the high standard and the lack of ability to locate comparables".

47. *Johnston v. M.N.R.*, 3 DTC 1182 (1948) S.C.C. Revenue Canada's initial assessment of the White Paper does not seem to focus at all on the rebuttable presumption aspect of the periodic adjustment rule.

48. *R.T. French Co. v. Comm'r*, 60 T.C. 836 (1973). In *French*, the court rejected an IRS contention that a related party license should be treated as having an adjustment clause; the decision seems to have been based on the premise that, either, on the facts in that case, or, in general, third parties do not renegotiate contracts once entered into. It must be assumed (having regard to the discussion on the White Paper) that a rehearing of *French* before a court under pre-1986 law, would either compel a court to decide that *French* was erroneously decided or, if correctly decided, then distinguishable (in relevant circumstances) on the basis that in some case (at least according to the data cited in the White Paper) third parties do in fact provide for post-contractual renegotiations.

49. White Paper at 63.

50. Id.

51. White Paper at 63-64.

52. White Paper at 64.

53. The IRS's sources are being questioned. See John S. Nolan, "Application to Goods and Services: Comparables, Basic Rate of Return Method, Profit-Split", Georgetown Conference, supra note 6, at 5. Revenue Canada's John Calderwood puts the question as follows: "It is not known if unrelated parties generally provide for changes through the contract period. It would seem unusual for a licensee to accept a downward return." (John Calderwood, Canadian Tax Foundation, supra note 6, at 16).

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would exist by definition, which would determine the consideration for the related person transfer, both initially and over time. Comparables are always the best measure of arm's length prices.[54]

The latter point is considered to be inapplicable in the case of high profit intangibles unless there is an "exact comparable". Mere "inexact" comparables will not automatically prevent periodic adjustment. The White Paper stipulates that periodic adjustments will not be made where a taxpayer can demonstrate each of the following 3 factors, in respect of inexact comparables:

(1) that events had occurred subsequent to the license agreement to cause the anticipated profitability;
(2) that the license contained no provision pursuant to which unrelated parties would have adjusted the license; and
(3) that unrelated parties would not have included a provision to permit an adjustment for the change to cause the unanticipated profitability.[55]

In other words, it would be open to taxpayers to rebut the presumption by bringing adequate proof of the foregoing factors. In this respect the White Paper states "it would be appropriate to impose a high standard of proof, such as a clear and convincing evidence standard[56], on taxpayers in order to demonstrate that the subsequent profitability could not have been anticipated" and, furthermore, "in no event should this test be available to taxpayers if inexact comparable licenses with no provision for periodic adjustments cannot be found in the marketplace".[57]

The fact that the White Paper suggests that the penalty sections of the Code should be beefed-up to the extent that taxpayers do not voluntarily effectuate periodic adjustments, when called for under the principles just noted, and the potential issues on audit which may arise from the periodic adjustment requirement (including the necessity to achieve correlative adjustments in other countries such as Canada) does not, per se, mean this requirement, as explained in the White Paper, is inherently inconsistent with the arm's length standard, as understood in Canada and other countries. Perhaps one effect of super royalty in general and the periodic adjustment requirement in particular, will be pressure on tax authorities to provide advance approval for intangible transfer arrangements. This could be a type of advance ruling through the competent authority procedure, although Revenue Canada has been reluctant in the past to entertain such rulings, primarily on the basis that an advance ruling would limit its flexibility in the event of any subsequent competent authority procedure respecting the subject matter of the ruling.

The White Paper's recommendations respecting periodic adjustments in respect of lump-sum payments[58] may prove troublesome in coordinating adjustments with other countries. Rather than make an adjustment in the year of sale (when it becomes evident that the price received was too low and the presumption that there should be a change cannot be rebutted), the White Paper suggests, in order to avoid certain administrative issues, a convoluted formula-approach designed to loosely spread the super royalty adjustment over the number of years associated with the period during which the transferee benefits from the transferred intangible. Under Canadian law, there is generally no basis to readjust the transaction except in the year of sale.[59]

Where there are no comparables and the arm's length return method is used, period adjustments are an inherent part of the process of identifying factors of production used by the parties in allocating income in respect thereof: the income allocation adjusts as the factors change. The very essence of this method is an allocation based upon assessment of the contribution made; does this not evolve on an ongoing basis? This method would not appear to depart from the existing views and that of the United States or under the 1979 OECD guidelines respecting the nature and use of "other" or "fourth" methods. In essence, periodic adjustments are simply an inherent part of such methods and should not be seen as constituting a new pricing rule in either the United States or elsewhere. The point is summarized in the White Paper as follows:[60]

> Thus, as an affiliate's plant, equipment and other measurable factors change from the projections in the initial analysis, the income allocated to them should change. Similarly, the profit split percentage is intended to reflect the relative values of significant intangible assets owned by the parties. When the value of intangibles belonging to one of the parties has changed, the percentage should be changed.[61]

5. Summary

The White Paper distinguishes between normal profit intangibles and high profit potential intangibles. The former are considered to relate to widely used products where comparables would often be available to assess intercompany licensing fees. The latter entails unique and unusual products which may be expected to generate profits far beyond the returns normally found in the industry, where third party licenses generally would not arise and, accordingly, where the special vigour of the super royalty rules are required.[62]

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54. White Paper at 64.
55. White Paper at 65.
56. See note 35.
57. Id.
58. White Paper at 68-69.
59. However, Art. IX of the Canada-U.S. Income Tax Convention could authorize such adjustments. See also *Aluminum Co. of Canada Ltd. v. The Queen*, 74 DTC 6408 (F.C.T.D.).
60. White Paper at 102.
61. Revenue Canada is particularly concerned about retroactive adjustments under the periodic adjustment rule. Commenting on conclusion No.4 of Chapter 8 of the White Paper (that periodic adjustments generally be prospective unless a different royalty rate would have been set on the date of transfer based upon expectations of the parties) John Calderwood, Canadian Tax Foundation, supra note 6, states at 17: "The above statement is not too clear. We hope it suggests the taxpayer is not expected to use hindsight in making periodic adjustments".
62. However, even in the case of high profit potential intangibles, the White Paper concedes that valid comparables would govern (at 52): "In the rare instance in which there is a true comparable for a high profit intangible, the royalty rate must be set on the basis of the comparable because that remains the best measure of how third parties would allocate intangible income".

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Inasmuch as such intangibles normally are not licensed to unrelated parties, comparables are not available, and it is inadequate to have reference to royalty rates, which often arise in respect of normal profit intangibles. Therefore, third party royalty rates cannot be utilized on some adjusted basis and rather, in the language of the White Paper, "enactment of the commensurate with income standard was thus a directive to promulgate rules that would give primary weight to the income attributable to a transferred intangible in determining the proper division of that income among related parties".[63]

Do Revenue Canada's views, as expressed in the Information Circular, clash with this thought?

Is para. 45 of Revenue Canada's Information Circular (which as noted earlier states that in the absence of comparables, "the best that can be expected is to draw comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions and similar licensing arrangements") in conflict? The difficult situations targeted by the White Paper (with respect to high profit potential intangibles) do not involve "relatively similar products", "similar market conditions" and "similar licensing arrangements". Moreover, as already noted, paras. 11, 12, 13, 15 and 47 of the Information Circular clearly foresee that where situations are not comparable, proper pricing will involve some sort of allocation based on assessment of the "relative contributions of the parties to the license".[64] This is clearly the aim of super royalty as explained by the White Paper.

As discussed above, the controversial periodic adjustment aspect of the super royalty may not be in conflict with Canadian law. That feature, as interpreted by the White Paper, will have no application whatever where there are so-called "exact" comparables and in the case of inexact comparables, the rule seems to be nothing more than a rebuttable presumption. In the Canadian context this could take the form of assumptions of facts by Revenue Canada in raising assessments. In cases where there are no comparables at all, the periodic adjustment rule is simply another of the unique factors to be taken into account in applying a facts and circumstances evaluation based on functional analysis of the relative economic contributions by the parties and the relative economic risks assumed by the parties.

As well as consistency in underlying principles, the methodology of their application, advocated in the White Paper (i.e. the basic arm's length return method or the profit split method), can be viewed as a reasoned approach to an "other" or "fourth" method, required where comparables do not govern and, as such, not in conflict with Canadian law.[65]

The White Paper proposals, although more sophisticated than anything seen to date in Canada, can be viewed as one means of achieving the objective stated in paras. 11, 12 and 15 of the Information Circular (discussed above). Where comparables do not govern, as discussed in para. 14 (leaving aside the secondary resale and cost plus method), the Circular in para. 19 acknowledges the requirement for "other methods" – as well as the subjectivity involved therein. Para. 19 reads as follows:

> Other methods may be employed in support of one of the three aforementioned methods or in the circumstances where none of these methods is appropriate. This is consistent with the recommendations of the OECD. The method utilized should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm's length relationship.

The 2 basic fourth methods advocated by the White Paper seem to be designed to answer the question: "what would have transpired in an arm's length relationship"? This objective also underlies Revenue Canada's approach to transfer pricing. Both countries agree that where there are valid comparables, they should govern to the exclusion of any other method. Both countries agree that in the absence of comparables, the pricing should seek to arrive at results for both parties which likely would have arisen had they been dealing as third parties. The White Paper, relying upon a combination of U.S. case law and economic theory (some of which has helped shape U.S. case law) goes into much detail as to how this process is to be accomplished. The Information Circular (leaving aside the rather narrow points made in para. 20) provides no elaboration. However, the approach of the Federal Court in *Indalex* does suggest that to the extent the methodology proposed by the White Paper is viewed as a reasonable approach to simulating transactions between unrelated parties, it should be given careful consideration by Revenue Canada.

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63. White Paper at 52.
64. See para. 47 of the Information Circular.
65. Para. 56 of the Information Circular states that arm's length pricing is assessed on a transaction by transaction basis: "This approach is necessary because the Income Tax Act applies to each transaction between the various related parties and not to the Canadian taxable income, return on sales, return on equity or any other measurement of general profitability". The White Paper (at 59) notes that although the 1979 OECD Report considers the arm's length inconsistent with "global" methods for transfer pricing, including, for example, "allocating profit in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labor forces, or by some formula taking account of several such criteria", the White Paper notes that the OECD does recognize that adjustments may be made and that "nowhere, however, does the report suggest that the profit related enterprises are relevant to this determination" (at 60). Moreover, the White Paper notes that the 1979 OECD Report "specifically authorizes an inquiry into profits or profitability", and moreover provides for analysis of economic functions to determine "when a profit is likely to arise and roughly what sort of profit it is likely to be". Furthermore, the White Paper notes that the OECD Report deals with methods that permit "reference to comparable profits or returns on capital invested as a means of determining the appropriate transfer prices". In light of these factors, the essential nature of the super royalty rule as explained in the White Paper and Revenue Canada's position in various parts of the Information Circular as described above, it is doubtful whether Revenue Canada will consider its statement in para. 56 of the Circular as constituting a bar to acceptance of prices determined in accordance with the principles of the super royalty rule.

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C. Effects on Revenue Canada's approach to auditing Canada–U.S. issues

A preliminary observation by U.S. practitioners who have had an opportunity to study the White Paper is that the recommendations concerning procedural matters (maintenance of transfer pricing information on a current basis in taxpayers' books and records, beefed-up reporting of transfer pricing methods on Forms 5471 and 5472 and the specter of more substantial penalties for failure to disclose information or a substantial understatement of income) are the real problems raised by super royalty and the White Paper. The concerns underlying these proposals are not restricted to the IRS. Canada's tax reform has resulted in statutory amendments designed to increase Revenue Canada's ability to audit international transfer pricing issues.[66]

It would seem clear from Revenue Canada's standpoint that the White Paper initiative in this area is highly favorable as it should dovetail with its own efforts in assessing intercompany pricing arrangements involving Canadian and U.S. companies. In particular, the information arising under these rules would presumably be available to Revenue Canada through the treaty exchange of information provisions and may alleviate the difficulties which Revenue Canada now experiences in determining the basis upon which charges are made to Canadian subsidiaries of U.S. companies. This is particularly so where such information would include, as suggested in the White Paper, data the taxpayer has gathered concerning comparable transactions and analysis it has prepared concerning rates of return, profit splits or other information or analysis which the taxpayer has used in arriving at its transfer prices.

D. Effects on Canadian subsidiaries of U.S. parent companies

As noted earlier, an unfortunate aspect of super royalty is that it has clearly been enacted in light of the abuses involving offshore subsidiaries of U.S. multinationals, a problem not germane to Canada–U.S. transfers. Notwithstanding the relatively narrow focus of the problem, the scope of the super royalty rule has not been limited to the abuse for which it was really legislated.

Super royalty would never have been enacted in relation to transactions between U.S. companies and affiliates in high tax jurisdictions such as Canada; yet typical of the shotgun approach to anti-avoidance tax legislation, the rule is written to apply indiscriminately. Neither the statutory enactment nor the White Paper limit its application.

Conceptually, the new rules may be particularly troublesome where intangibles are transferred to Canadian subsidiaries which essentially perform a service function and do not carry on their own viable and independent manufacturing and marketing operation and do not develop and eventually own its separate high value intangibles. In such case, the method mandates an allocation of residual income to the U.S. company (utilizing the arm's length return method) without a profit split. Such effects do make sense but will be countenanced only if Revenue Canada accepts the allocation as reflecting the true economic relations between the U.S. parent and the Canadian subsidiary. In such case, consistent treatment by the 2 countries will not be difficult to achieve.

In any other cases, i.e. where the Canadian licensee is in fact carrying on its own separate viable business, it is difficult to imagine that Revenue Canada will not accept the theory of allocation advanced in the White Paper that is based on profit splits entailing some valuation of the separate intangibles owned by each company.

The profit split concept should provide common ground on which the requirements of the U.S. and Canadian rules may be reconciled, particularly if the IRS adopts a generous approach in assessing the value of the functions performed by the Canadian affiliate and its own intangibles with respect to sales promotion, marketing, packaging, distribution, transportation, etc. However, this ultimately entails nothing more or less than a facts and circumstances inquiry designed to distinguish between the amount of income attributable to the right to use the intangible and the amount attributable to the efforts made by the licensee to exploit, through its manufacturing and marketing process, the technology and other intangibles granted under the relevant license, as well as the separate intangibles developed by the licensee.

As noted earlier, the overall effect of tax reform in both countries serves as an incentive for U.S. companies to increase charges to their Canadian subsidiaries in order to reduce the potential for excess foreign tax credits. It is suggested, in view of the foregoing observations, that super royalty should not, per se, result in increased charges to Canadian subsidiaries where either governed by valid comparables or in other cases where such charges have been formulated in accordance with the economic principles underlying the proposed fourth methods of the White Paper. The controversy surrounding super royalty, however, may have established an expectation on the part of taxpayers and Revenue Canada that there will be pressure to increase licensing fees or cost sharing contributions, and undoubtedly all such arrangements will be subject to closer scrutiny from Revenue Canada than in the past.[67] On the other hand, it is likely that

66. See new Secs. 231.6 and 233.1 and amended Subsec. 152(4) of the Act. See Nathan Boidman, "Canadian Tax Reform Proposals – A Response to the U.S. Tax Reform Act of 1986", 16 *Tax Management International Journal,* No. 8 (August 1987) at 318; Janice McCart, "Revenue Canada Access to Foreign Information and Documents", Report of Proceedings of the Fortieth Tax Conference, Canadian Tax Foundation, 1988 (not yet published), and Allan R. Lanthier, "Canada: Tough Time Ahead for Multinationals?", 41 *The Tax Executive,* No. 2 (Winter 1989) at 130.

67. Consistent with Revenue Canada's concerns noted elsewhere in this article is the following statement by John Calderwood to the Canadian Tax Foundation conference, supra note 6, at 38-39: "Generally, Revenue Canada Taxation agrees with the approach taken where tax havens and posses-

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the IRS will be more focussed on transactions either involving the type of tax haven arrangements which prompted Congress to enact super royalty or the transfer of intangibles to U.S. companies by foreign groups and there will be less attention to licenses by U.S. companies to subsidiaries in high tax jurisdictions such as Canada.

It is also theoretically possible, although unlikely in practice, that U.S. parent companies will be motivated to increase charges to Canadian subsidiaries in order to avoid licenses being recharacterized as a transaction subject to Sec. 367(d) of the Code, which results in the deemed income therefrom being treated as U.S.-source income and thus not eligible for foreign tax credit relief. The White Paper[68] describes the situation as follows:

> Moreover, a license payment that is less than some specific percentage of the appropriate arm's length amount could be considered so devoid of economic substance that the arm's length charge should be subject to section 367(d). Thus, those related party transfers which deviate substantially from the proper commensurate with income payment would be subject to section 367(d), even if cast in the form of a sale or license.

Is it clear that any such resourcing would only apply to the deemed income and not to the actual payment made under the license? Does Art. XXIV of the Convention override the domestic (Sec. 367(d)) sourcing rule? Would not such a situation, in any event, be worked out through an Art. IX competent authority procedure? This illustrates the type of less obvious issues which may arise out of super royalty, although in this particular case the basis was established by the 1984 enactment of Sec. 367(d). The White Paper does not provide very much, if any, guidance in this area.

Para. 212(1)(d) of the Act and Article XII of the Convention levy a 10% withholding tax on royalty payments under a license or payments of a contingent nature in respect of an outright assignment but not on lump-sum payments in respect of an outright assignment. Where excessive charges are made to a Canadian company and not otherwise subject to withholding (e.g. in respect of lump-sum payments for an outright assignment), withholding tax on a deemed dividend pursuant to the combined provisions of Sec. 15 and Part XIII of the Act could arise, although here again, in the context of a U.S. parent and a Canadian subsidiary, the withholding rate would be reduced to 10%, in this case by Art. X(2)(a) of the Convention. Where such charges are made by an offshore affiliate of a U.S. based multinational, treaty rates would not apply and the withholding would be at 25%. In relation to excessive charges and the provisions of Sec. 15 in this context, reference should be had to *Indalex* pursuant to which the excess payment to an offshore affiliate of a U.S. parent would not qualify as deemed dividend to the U.S. shareholder, with the result that the withholding rate would be 25% and not 10%.

E. Effects on Canadian parent companies with U.S. subsidiaries

The White Paper also confirmed[69] that the super royalty rule applies to "inbound" transfers, i.e. licenses and other transfers of intangibles to U.S. companies, as well as "outbound" transfers. Contrary to initial impressions, before the release of the White Paper, the super royalty rule no longer appears to be the basis for a Canadian multinational to charge inordinate amounts to U.S. related licensees of intangibles.[70] This is merely the flip side of the foregoing discussion and to the extent that the super royalty rule does not depart from the arm's length standard, it would appear that super royalty will only affect Canadian licensors in 2 ways. First, it may provide a conceptual framework upon which licensing charges properly can be increased from preexisting levels (assuming, in effect, inadequate charges in the past). As well it will provide, in respect of future licenses, a rationale for extracting the maximum amount of royalties based on the relative contribution theory underlying the arm's length return method (where, of course, comparables do not govern). Second, the record keeping requirements concerning the basis upon which licensing arrangements are established will undoubtedly add a substantial degree of complexity in dealing with such intercompany transactions.

F. Cost sharing arrangements

Cost sharing arrangements do not seem to pose any particular problem in the Canada–U.S. context and nothing in the White Paper suggests that this will change.[71] The White Paper notes that "Congress intended to permit bona fide cost sharing arrangements, but expected the economic results of such arrangements to be consistent with the commensurate with income standard".[72]

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sion corporations are involved. However, it would have preferred to see a clearer position taken where treaty partners are involved and this appears to be the consensus among other treaty partners ....
In conclusion, it would appear that the competent authorities' workloads, and those of corporate groups as well, may well increase as a result of the Section 482 White Paper".

68. White Paper at 53.

69. White Paper at 48.

70. It is not widely recognized that aggregate Canadian federal and provincial corporate tax rates may be less than the effective overall U.S. federal and state taxes which would apply to U.S. effectively connected income earned by a U.S. subsidiary or branch of a Canadian corporation, particularly where there is factored in applicable secondary U.S. taxes (i.e. either dividend withholding taxes in the case of a U.S. subsidiary or branch profits tax in the case of a U.S. branch). As a result, Canadian companies often have as much incentive to maximize charges against U.S. profits as do U.S. parent companies against Canadian profits.

71. Revenue Canada generally agrees with the thrust of the White Paper's approach to cost sharing arrangements although Mr. John Calderwood, Canadian Tax Foundation, supra note 6, at 22, expresses concern about the basic assumption of the White Paper (that Congress intended to permit cost sharing arrangements if they produce results consistent with the super royalty rule): "Revenue Canada Taxation takes the position that normal arm's length standard, not the commensurate with income standard, should prevail".
This of course is reconcilable if the thesis herein, i.e. that super royalty does not in fact depart from the arm's length standard, is valid. Further, at 24, Mr. Calderwood states: "Revenue Canada Taxation has reservations regarding periodic adjustments but otherwise believes the position (that cost sharing is to be borne by each participant proportionate to the reasonably anticipated benefits to be received) taken is not unreasonable". (parenthetical words added)

72. White Paper at 4.

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The detailed discussion in Chapters 12 and 13 indicates that provided the arrangement generally makes "economic sense", i.e. the parties contribute amounts in proportion to reasonably projected share of benefits from the exploitation of the product of the shared R & D program – there are only 3 meaningful issues:

(1) Is the participation of a particular unit of the multinational in the program tailored to distort results for tax purposes by having low tax affiliates "cherry pick" (i.e. participate only in successful R & D programs)?

(2) Do affiliates in high tax jurisdictions participate in programs not particularly relevant to their manufacturing and sale activities?

(3) Are so-called "buy-in" payments designed to adequately compensate a member of the cost sharing group for a contribution of either specific resources to the cost sharing group exceeding the cost shares otherwise arising or of intangibles resulting from prior and separate R & D of one of the members?

The latter 2 issues can arise in the context of Canadian participation in U.S. (parent) sponsored cost sharing arrangements.

Paras. 34-39 of the Information Circular deal with cost sharing arrangements. The basic notion is expressed in para. 35. In considering deductibility of contributions by a Canadian affiliate to a cost sharing arrangement, "the Department will look to the nature and quantum of the benefits received" and "the Canadian taxpayer obviously must be in a position to benefit from the R & D, if not immediately at least potentially, by having a genuine and substantial interest in the results". This mirrors the second issue noted above.[73] The Circular indicates, in para. 37, that whatever the method utilized, it "should be appropriate to the particular circumstances in each case" and notes that "it is not possible to specify any basis of allocating the expenses being preferable".

Revenue Canada's Information Circular does not deal with the "buy-in" issue simply because its views on cost sharing arrangements are expressed in the context of projects undertaken by foreign companies to which the Canadian member of the multinational makes contributions.

The first issue (related to the *Lilly* and *Searle* situations, where intangibles were transferred to a tax haven affiliate) is not, therefore, a concern for Revenue Canada and hence there is no discussion thereof in the Information Circular.

With respect to the second issue, reflecting a concern shared by both Revenue Canada and the IRS, the White Paper delves into the following aspects of the question of determining the relationships between contributions made and benefits:

(1) Is the range of products covered by the agreement too broad or too narrow, relative to the expected participation in manufacturing and marketing by the participating parties?
(2) Are the participants in the cost sharing group assigned exclusive geographic rights?
(3) Do the participants engage directly in the exploitation of the intangible?
(4) What is the appropriate method of measuring anticipated benefits?
(5) Are periodic adjustments to the cost sharing arrangements required?
(6) What are the appropriate direct and indirect costs to be shared?
(7) Should there be a profit element?
(8) Should cost sharing arrangements extend to "marketing intangibles"?
(9) Should there be particular formalities respecting such arrangements?

The objectives of the White Paper in this area seem to be totally consistent with those of Revenue Canada. For example, it is obvious that if a Canadian company enters into a cost sharing agreement and the rights to exploit the Canadian marketplace represent 2% of the world market, it would not be reasonable for the Canadian company to contribute more than 2% towards the cost of the project. This is another instance of a facts and circumstances evaluation and is expressed in the White Paper as follows:

> Underlying all of the problems discussed in the legislative history of the 1986 Act in relation to cost sharing arrangements is the fundamental principle that the costs borne by each of the participants should be proportionate to the reasonably anticipated benefits to be received over time by each participant from exploiting intangibles developed under the cost sharing arrangement. This cost share/benefit principle has several facets, including the appropriate product area to be covered (discussed in section B above), definition of costs to be covered (discussed in section D below), and the measurement of anticipated benefits and several other issues discussed below.[74]

Inherent in such process is periodic adjustment. The White Paper advocates that "the cost shares should be adjusted periodically on a prospective basis to reflect changes in the estimates of relative benefits including a change in the measurement standard if that becomes appropriate".[75]

V. SUMMARY

Rules for intercompany transactions in the United States, Canada and those several other countries which base their systems on the 1979 OECD Report essentially comprise, irrespective of the format or language in which they are couched, 2 elements:

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73. A subsidiary theme in the Information Circular is whether or not there should be a profit or mark-up charge on the R & D function and the effect thereof on withholding taxes, under Part XIII (see para. 38 of the Circular). Revenue Canada reiterates its position, expressed in IT-303 and IT-303 Special Release, that a payment will not qualify for exemption under para. 212(1)(d)(ix) if there is a profit element in the amount allocated to the Canadian participant. There appears to be no statutory basis for this restrictive view. As well, there can be some question as to the applicability of withholding taxes where the conditions of para. 212(1)(d)(ii) do not apply. See Nathan Boidman, "Revenue Canada's Transfer Pricing Circular: Selected Commentary", 36 *Canadian Tax Journal*, No. 2 (March-April 1988) at 405.
74. White Paper at 116-117.
75. White Paper at 120.

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(1) All countries give primacy to objective comparables (when available) as the means of establishing intercompany transactions (a true arm's length standard). This excludes the majority of cases.

(2) In the majority of cases where valid comparables are not available, there are no specific rules per se; the matter is left to a facts and circumstances evaluation (except where political subdivisions impose arbitrary formular approaches as seen under certain state law in the United States and inter-provincially in Canada). Super royalty simply seeks to impose a rigorous functional analysis basis method for allocating income without establishing specific mathematical formulae.

Viewed in the foregoing fashion, super royalty does not breach international standards or conflict with Canadian law. Where there are valid comparables, the rules remain unchanged; where there are no valid comparables, super royalty adds, at best, a new dimension (and a rebuttable presumption) which may depart from international standards in form but not in substance.

The White Paper's analysis also serves as a reminder that the arm's length principle can be fully achieved only where objectively determinable comparables are available. In other cases, intercompany transactions cannot really be evaluated by reference to an arm's length standard and governments have to choose between 2 very different approaches:

- The matter can be left to the courts, which will determine an appropriate price on the basis of facts and circumstances (although super royalty may elevate the process to a quasi-science, not totally an art). In this approach the courts seek to simulate how parties might have acted in an open market environment. This process, however, cannot be expected to provide consistent results.
- Instead governments can abandon, entirely, any attempt to have the matter resolved by conditions in the market and rather adopt, on a comprehensive basis, formular-based apportionment methods which, on the one hand, may be arbitrary in design, but on the other would at least provide certainty for all parties, taxpayers and tax authorities alike. Unfortunately, the very useful analysis in the White Paper tends to show that substantial numbers of different formular approaches would be required if totally skewered and inappropriate results are to be avoided.

Both Canada and the United States reject the latter approach.[76] The White Paper should serve to eliminate or reduce concern that super royalty will give rise to substantial issues leading to double taxation. Conversely, it is fair to state that Congress created a mountain out of a molehill because, it is suggested, the changes advocated in the White Paper could have been achieved by simply modifying the regulations under Sec. 482 without any statutory enactment.

Secs. 936(h), 367(d) and 482, prior to the 1986 enactment, provided a basis to deal with the mischief with which Congress was concerned without raising fears in international tax circles of impending chaos. A careful reading of the White Paper shows that super royalty, as interpreted therein, should not supplant the arm's length standard and the White Paper's analysis will indeed help to crystallize the problems with the arm's length standard (where comparables do not exist) in a fashion which should serve taxpayers and tax authorities in all countries.

The "new" rules should only be of concern in situations where taxpayers seek to manipulate transfer pricing for high profit intangibles.

The criticism levied against the White Paper to date seems to be premised upon a distorted view of its proposals. The forest is being lost for the trees. Although it seems relatively clear that the arm's length return method would at most provide a more focussed framework to deal with transactions which cannot be objectively measured by comparables, critics to this point take issue with the particulars of both the theory and the examples by which the nature of such an inherently flexible and subjective principle is explained and illustrated in the White Paper. These discreet elements are elevated to the status of fixed rules of law and then criticized for their shortcomings rather than being seen in the context of a fourth method approach, which by its very nature requires a high degree of judgment based on the particular facts and circumstances surrounding each case. In more than one place and in more than one way, the White Paper qualifies the discussion of the arm's length return method as a means to an end and not an end itself and it would seem that nowhere does the White Paper seek to cast in concrete any of the particular elements comprising the suggested rules or applications thereof.

In summary, it seems that the White Paper is an excellent and extremely useful analysis and description of the law governing intercompany transactions in the context of the super royalty legislation and the ways in which such law can be improved. Moreover, to the extent that the White Paper accurately reflects the intention of Congress, it should serve to allay the fears of taxpayers and foreign governments that super royalty did in fact radically change the arm's length rules. It is suggested that it did no such thing and if anybody should be criticized it is not the IRS and the Treasury but the Staffs of the House and the Joint Committee for escalating what otherwise was a perfectly sensible reaction to the abuses perceived in cases such as *Lilly* and *Searle* into something other than a requirement to beef up or adjust the Regulations – the necessity of which itself may be somewhat questionable given the support that courts have given the IRS in such cases to date.

76. Chapter 10 of the White Paper examines the use of formular methods and concludes that "the market-base arm's length standard remains the better theoretical allocation method". One way of assessing the risk of significant arbitrariness with any type of rigid apportionment formula is to consider the discussion in the White Paper respecting the priority of pricing methods, where exact comparables do not govern. Facts and circumstances can lead to at least 4 different theories respecting the choice of appropriate pricing methods (as between "inexact" comparables and the arm's length return method). The variety of situations requiring distinctive and varying approaches is a good indication of the risk of arbitrary results where a single or small number of fixed apportionment method are used.

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Tax Reform in Japan

Yukio Matsui and Hiroo Kato

I. INTRODUCTION

The Japanese tax reform was enacted in December 1988. This article outlines the amendments to the Japanese tax law with respect to the corporation income tax (national tax), the individual income taxes (both national tax and inhabitants tax) and the new consumption tax.

In addition to the December 1988 tax law changes, certain amendments were made to the special Taxation Meàsures Law. These changes were generally effective 1 April 1988 and are not covered in this article. One of the most significant corporate tax law changes in these amendments was a reversion to the former loss carry-back (one year) and loss carry-forward (5 year) rules for periods ending on or after 1 April 1988.

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Table I

	Present		New		
	Taxable income		Taxable income		
			1989		1990
	Earmarked for dividends %	Balance %	Earmarked for dividends %	Balance %	All income %
1. Corporation with paid-in capital in excess of ¥ 100 million	32	42	35	40	37.50
2. Corporation with paid-in capital of ¥ 100 million or less and non-juridical associations, etc.:					
First ¥ 8 million of annual taxable income	24	30	26	29	28
Remainder	32	42	35	40	37.50
3. Co-operation associations, etc.	22	27	25	27	27

Table II

	Present		1989		1990
	Reduced rate	Regular rate	Reduced rate	Regular rate	All income
	%	%	%	%	%
Statutory rates					
Corporation income tax	32	42	35	40	37.50
Inhabitants tax					
(local tax) – 20.7% (maximum rate) of corporation tax due	6.62	8.69	7.25	8.28	7.76
Enterprise tax					
maximum rate	13.20	13.20	13.20	13.20	13.20
	51.82	63.89	55.45	61.48	58.46
Effective rates					
(resulting from the deductibility of enterprise tax on a payment basis)	44.37	56.44	48.28	54.31	51.64

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II. CORPORATION INCOME TAX (NATIONAL TAX)

A. Corporation tax rates

Corporation tax rates are reduced. However, the reduced tax rates applicable to taxable income earmarked for dividends have been repealed. The new tax rates apply to accounting periods beginning on or after 1 April 1989 and 1990, respectively (see Table I, above).

1. Combined income tax rates

In addition to the corporation income tax, a Japanese corporation is also subject to 2 local taxes, i.e. an inhabitants tax and an enterprise tax. The inhabitants tax is computed as a percentage of the corporation tax and varies by municipality with a maximum rate of 20.7%. The enterprise tax also varies by location with a maximum rate of 13.2% and is deductible when paid for national tax, inhabitants tax and enterprise tax purposes.

The regular corporate income tax rates (Table II) apply for both Japanese corporations and branches of non-Japanese corporations. However, the reduced rates are only available to Japanese corporations, regardless of the nationality of shareholders, and are applied to the portion of taxable income that is earmarked for dividends. Dividends consist of both cash or stock dividends and interim cash dividends, if paid, less dividends (net of non-deductible interest expense) received from other Japanese corporations.

2. Planning for dividend repatriation

In general, a Japanese subsidiary of a U.S. multinational that declares earnings as a dividend before the Japanese tax return is filed for that year will be entitled to the reduced tax rate under the present split rate system. If dividends exceed taxable income, the reduced rate will not be applicable to the excess.

Example

Assume J corporation, a Japanese corporation, estimates taxable income of 100,000 for its fiscal year ending 31 March 1989. The Japanese tax liability varies as shown below depending on the date the dividend is declared.

(1) Dividend declared in May or June 1989 before tax return is filed for the year ending 31 March 1989	100,000
Combined Japanese effective tax rate	44.37%
Japanese tax payable	44,370
(2) Dividend declared in May or June 1990 before tax return is filed for the year ending 31 March 1990	100,000
Combined Japanese effective tax rate	48.28%
Japanese tax payable	48,280
(3) Dividend for year ending 31 March 1991 declared after tax return for the year ending 31 March 1990 is filed	100,000
Combined Japanese effective tax rate	51.64%
Japanese tax payable	51,640

Accordingly, dividends should be declared by Japanese subsidiaries before such time as the Japanese income tax return is filed (including extension) in order to take advantage of the reduced rate under the present split rate system.

B. Dividend exclusion from taxable income

Under the old corporation tax law, a corporation could exclude dividends received from other Japanese corporations (i.e. excluding non-Japanese corporations, non-juridical associations, etc.) in the computation of its taxable income. However, the dividend exclusion will be reduced gradually over 2 years except for dividends from affiliates which are 25% or more owned.

	Present	New	
		1989	1990
Dividend exclusion	100%	90%	80%

The above revision applies to accounting periods beginning on or after 1 April 1989 and 1990, respectively.

C. Small sum depreciable property

Currently, depreciable property with an acquisition cost of less than ¥ 100,000 per item (as defined) is fully expensed when it is placed in service. Under the proposal, the limitation is increased to ¥ 200,000. This revision applies to depreciable property acquired on or after 1 April 1989.

D. Foreign tax credit

1. Computation of foreign tax credit limitation

Under the old law, all foreign-source income was included in the numerator for the calculation of the foreign tax credit limitation. Under the proposal, 50% of the income which is tax exempt in the foreign country of its source is not included in the numerator. In addition, the total foreign-source net income for foreign tax credit purposes are limited to 90% of the taxable income of the corporation.

2. Scope of foreign taxes

Foreign taxes eligible for the credit no longer include the portion attributable to rates exceeding 50% or a portion of withholding taxes levied at relatively high tax rates on interest.

3. Carry-back and carry-forward period

Both the excess of foreign tax paid over the foreign tax credit limitation and the unused foreign tax credit limitation may be carried back and forward 3 years instead of 5 years.

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4. Allocation of expenses

A more specific allocation method for expenses applies to prevent abuse of the foreign tax credit.

The above revisions apply to accounting periods beginning on or after 1 April 1989.

E. Capitalization of interest expense on debts for land acquisition

Interest expense on funds borrowed for the acquisition of land (including the right to use land and securities economically equivalent to land) by corporations will be capitalized. The capitalization period will begin on the date of acquisition and continue for the shorter of 4 years or the time when the land is placed in certain business usage, such as the construction of a building, etc. In the calculation of interest capitalized, a corporation can use either a deemed annual interest rate of 6% or the actual average interest rate of financing for the corporation.

The amount of interest expense capitalized can be expensed at the time of disposition of the land. If the corporation does not dispose of the land, the amount of interest expense capitalized can be amortized over the 4 years following the end of the capitalization period.

This capitalization provision excludes the following land:

- land placed in certain public businesses such as residential land development projects approved by the Minister of Construction under the Good Residential Land Development Promotion Act; and
- a certain percentage of the land acquired for sale or rental by a corporation which engages in the sale or rental of real estate.

The above revision applies to interest on funds borrowed for land acquired after 30 December 1988.

III. INDIVIDUAL INCOME TAX

A. National tax

1. Tax rates

National individual income tax rates are decreased, effective starting in 1988. The number of brackets dropped from 12 to 5 and the maximum rate from 60% to 50%.

	Taxable income (in ¥)	Tax thereon (in % or ¥)	On excess
Up to	3,000,000	10%	—
From	3,000,000	300,000	20%
	6,000,000	900,000	30%
	10,000,000	2,100,000	40%
	20,000,000	6,100,000	50%

However, for 1988 there will be one additional tax bracket of 60% for taxable income exceeding ¥ 50 million.

2. Other allowances and deductions

The statutory personal allowances and deductions have been increased, effective with the calculation of national income tax for 1989, as follows:

a. *Personal allowances*

– Basic exemption	¥ 350,000
– Old age allowance (for a taxpayer aged 65 or over whose aggregated taxable income does not exceed ¥ 10 million)	(Unchanged) 500,000
– Widow allowance (for a taxpayer with a dependant or dependants, who does not qualify for the old age allowance. If aggregated taxable income does not exceed ¥ 3 million, no dependant is required)	270,000
– Widower allowance (for a taxpayer who does not qualify for the old age allowance, having aggregated taxable income less than ¥ 3 million and with a child or children whose aggregated taxable income does not exceed ¥ 350,000)	270,000
– Handicapped person allowance	270,000
– Severely handicapped person allowance	350,000
– Working student allowance (for a taxpayer who is a working student with taxable income (as defined) of less than ¥ 620,000)	270,000

b. *Dependant allowances*

An allowance for a spouse and other dependants is deductible if total income for the dependant does not exceed ¥ 350,000 (e.g. gross employment income of ¥ 920,000 a year if no other income is earned). The dependant allowances are as follows:

(1) *Dependent spouse*	
Non-handicapped:	
Age 70 or over	¥ 450,000
Age under 70	350,000
Handicapped:	
Handicapped	620,000
Severely handicapped	
– not living together	700,000
– living together	1,000,000
(2) *Other related dependants*	
Non-handicapped:	
Age 70 or over	
– not living together	¥ 450,000 each
– living together	550,000 each
Age under 70*	350,000 each
Handicapped:	
Handicapped	620,000 each
Severely handicapped	
– not living together	700,000 each
– living together	1,000,000 each
– age 70 or over and living together	1,200,000 each

* For other dependants who are 16 to 22 years old, the deduction is ¥ 450,000 instead of ¥ 350,000.

c. Additional special allowance for a spouse

In addition to the allowance for a dependent spouse

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described in "b" above, a special allowance for a spouse is granted to a taxpayer whose aggregated taxable income does not exceed ¥ 10,000,000. The maximum amount of this special allowance is ¥ 350,000. If the dependent spouse has no taxable income, this maximum amount can be applied. However, if the spouse has taxable income, this maximum amount is reduced. The reduction is based upon the taxable income of the dependent spouse.

This special allowance is calculated as follows:

(1) If the spouse is eligible for the allowance for a dependent spouse described in "b" above –

– Spouse has aggregated taxable income less than ¥ 50,000	¥ 350,000
– Spouse has taxable income of ¥ 50,000 or more	¥ 350,000 minus "Aggregated taxable income"

Note: Aggregated taxable income is rounded down to the nearest multiple of ¥ 50,000.

(2) If the spouse is not eligible for an allowance for a dependent spouse described in "b" above –

– Spouse has aggregated taxable income less than ¥ 400,000	¥ 350,000
– Spouse has aggregated taxable income of ¥ 400,000 or more	¥ 700,000 minus "Aggregated taxable income"

This above revision applies to the calculation of national income tax for 1989.

d. Others

A minimum standard deduction is allowed to cover necessary expenses for gross income derived from piecework employment of housewives. The amount of this deduction is ¥ 570,000. It is limited to the gross income generated by the piecework performed inside the home.

This revision applies to the calculation of national income tax for 1989.

A special deduction is available for necessary expenses of a taxpayer whose relatives work predominantly in his business. The amount of this special deduction is increased as follows:

	Special deduction
Spouse	¥ 800,000
Other than spouse	470,000

This revision applies to the calculation of national income for 1989.

In 1988 and prior years, to prevent any reduction in tax burden by arbitrarily distributing income from assets (such as interest, dividends and real estate income) among family members in one household, such distributed income was aggregated for tax purposes under certain conditions. This aggregation requirement is repealed for the calculation of national income tax for 1989 and thereafter.

3. Taxation on gains derived by individuals from disposition of securities

Until 31 March 1989, gains earned by individuals from the disposition of securities were usually tax-free. However, this treatment has been changed as follows:

A resident taxpayer or a non-resident taxpayer with a permanent establishment in Japan is subject to income tax on gains derived from the disposition of securities (stocks, convertible bonds, etc.). The gains are not subject to withholding tax but are subject to separate taxation at a flat tax rate of 20%. However, the following gains are not taxed separately, but are aggregated with other income and taxed at the graduated rates:

- gains derived from futures;
- gains derived from disposition of a golf club membership in the form of securities;
- gains derived from disposition of equity shares which are acquired before the date of the original public offering, but disposed of within one year after the original public offering. (However, if such equity shares have been owned for more than a 3-year period as of the date of the original public offering, only 50% of the gains derived from disposition made within one year after the original public offering should constitute taxable income.)

The following computation rules will apply:

(1) The net taxable gain will be the total of gains less the total of losses during the year derived from disposition of securities.
(2) A net loss incurred as a result of netting total gains with total losses during the year will not offset other income nor be carried forward or back to other years.
(3) Taxpayers who received proceeds from the sale of securities must present official documents to the securities company. Official documents will include a resident card indicating the name and address of the recipient.
(4) A securities company which pays proceeds from the sale of securities to a resident taxpayer or a non-resident taxpayer with a permanent establishment in Japan must issue a certificate of payment.

Alternatively a taxpayer may elect a separate taxation method at a flat withholding tax rate of 1% on proceeds derived from the disposition of listed securities. The 1% rate will apply to sales to or through securities companies operating in Japan.

(1) The net taxable gain is deemed to be 5% of sales proceeds of securities. A tax rate of 20% is applied to the deemed gain. Thus, a rate of 1% results.
(2) The flat withholding tax method cannot be elected for margin transactions. Rather, the actual gain will be taxed at 20%.
(3) Securities companies will withhold income tax from sales proceeds.
(4) A taxpayer who elects separate taxation at a flat withholding tax rate must file an application. The application for election of separate taxation at a flat withholding tax rate will be filed through a securities company prior to the time of payment of sales proceeds. The securities company will in turn

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forward the application to the authorities. The application will be valid until cancelled. Re-election will not be restricted following cancellation.

(5) If the election of separate taxation at a flat withholding rate is made, the securities company will not be required to confirm the name and address of the taxpayer nor file a certificate of payment.

The above revision applies to the disposition of securities (as defined) on or after 1 April 1989.

4. Taxation of retirement allowances

Under the previous law, retirement allowance was taxed separately from other sources of income on only 50% of the net amount of the retirement allowance after the deduction of basic deductions. The basic deductions have been increased to ¥ 400,000 for each year of service with the company (¥ 700,000 for each year of the 21st year or later).

The revision applies to retirement allowances to be paid on or after 1 January 1989.

5. Special taxation of long-term capital gains derived from the transfer of real property

In order to stimulate the supply and development of land, the tax burden on long-term capital gains derived from the transfer of real property (such as land, rights to land, buildings and structures) has been reduced. Capital gains derived from the transfer of real property held for a period longer than 10 years as of 1 January of the year of transfer are treated as "long-term capital gains".

However, the holding period to determine short-term or long-term gains is shortened from 10 years to 5 years for the transfer of land, etc. (land and rights to land) made during the period from 1 October 1987 through 31 March 1990. As for the transfer of other real property (i.e. buildings and structures), the holding period to determine short-term or long-term gains remains at 10 years.

Long-term capital gains are not aggregated with other sources of income but are taxed separately. Tax rates applicable to net long-term capital gains are revised as follows:

	For the first net taxable gain of ¥ 40,000,000 (in %)	*Excess (in %)*
National tax	20	25.0
Local tax	6	7.5
	26	32.5

The above revision applies for 1989.

B. Local inhabitants (resident) tax

1. Tax rates

The individual local inhabitants (resident) tax rates have been changed as follows:

Taxable income	*Tax thereon Pre-fectural*	*Muni-cipal*	*Total*	*Percent on excess Pre-fectural*	*Muni-cipal*	*Total*
Up to ¥ 1,200,000	2%	3%	5%	—	—	—
From 1,200,000	¥ 24,000	¥ 36,000	¥ 60,000	2%	8%	10%
5,000,000	100,000	340,000	440,000	4	11	15

The above revision applies for the 1989 assessment based on 1988 income.

2. Other allowances and deductions

The statutory personal allowances and deductions are as follows:

a. *Personal allowances*

– Basic exemption	¥ 300,000
– Old age allowance (for a taxpayer aged 65 or over whose aggregated taxable income does not exceed ¥ 10 million)	(Unchanged) 480,000
– Widow or widower allowance (same qualification requirements as noted for national tax purposes)	260,000
– Handicapped person allowance	260,000
– Severely handicapped person allowance	280,000
– Working student allowance (for a taxpayer who is a working student with taxable income (as defined) of ¥ 620,000)	260,000

The above revision will apply for the 1990 assessment based on 1989 income.

b. *Dependent allowances*

In order to claim an allowance for a spouse or other dependant, the maximum allowable total income for a dependant is limited to ¥350,000. This income restriction relates to the same income base period as that of the taxpayer (i.e. the prior calendar year).

Dependent spouse	
Non-handicapped:	
Age 70 or over	¥ 350,000
Age under 70	300,000
Handicapped:	
Handicapped	560,000
Severely handicapped	
– not living together	580,000
– living together	740,000
Other related dependants	
Non-handicapped:	
Age 70 or over	
– not living together	¥ 350,000 each
– living together	420,000 each
Age under 70*	300,000 each
Handicapped:	
Handicapped	560,000 each
Severely handicapped	
– not living together	580,000 each
– living together	740,000 each

* If the other dependants are 16 years to 22 years old, the special allowance for other dependants of ¥ 350,000 is deductible instead of the regular allowance of ¥ 300,000.

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The above revision will apply for the 1990 assessment based on 1989 income.

c. *Additional special allowance for a spouse*

In addition to the allowance for a dependent spouse described in "b" above, a special allowance for a spouse is available for a taxpayer whose aggregated taxable income does not exceed ¥ 10,000,000. The maximum amount of this special allowance is ¥ 300,000. If a spouse has no taxable income, this maximum amount can be applied. However, if a spouse has taxable income, this maximum amount is reduced.

If aggregated taxable income of a spouse is more than ¥ 700,000, this special allowance cannot be applied.

This special allowance is calculated as follows:

(1) If a spouse is eligible for an allowance for a dependent spouse described in "b" above –

– Spouse has aggregated taxable income less than ¥50,000	¥ 300,000
– Spouse has taxable income of ¥50,000 or more	¥300,000

Aggregated taxable income × 30/35

(Note: Aggregated taxable income is rounded down to the nearest multiple of ¥50,000).

(2) If a spouse is not eligible for an allowance for a dependent spouse described in "b" above –

¥600,000

Aggregated taxable income × 30/35

The above revision will apply for the 1990 assessment based on 1989 income.

d. *Others*

A minimum standard deduction is allowed to cover necessary expenses for gross income derived from piecework employment of housewives. The amount of this deduction is ¥ 570,000. This revision applies for the 1989 assessment on 1988 income.

A special deduction is available for necessary expenses of a taxpayer whose relatives work predominantly in his business. The amount of this special deduction is increased as follows:

	Special deduction
Spouse	¥ 800,000
Other than spouse	470,000

The above revision will apply for the 1990 assessment on 1989 income.

Under the present law, to prevent any reduction in tax burden by arbitrarily distributing income from assets (such as interest, dividend and real estate income) among family members in one household, such distributed income is aggregated for tax purposes. This tax treatment is repealed for the 1990 assessment and thereafter.

3. Taxation on gains derived by individuals from disposition of securities

Under the old law, gains earned by individuals from the disposition of securities were generally tax-free. However, this treatment has been changed and they are taxed as follows:

Taxpayers (individuals) who earn gains derived from the disposition of securities (stocks, convertible bonds, etc.) are subject to separate taxation at a flat rate of 6% unless the election of separate taxation at a flat withholding tax rate is made for national income tax purposes.

However, gains which are subject to aggregated taxation for national income tax purposes are also subject to aggregated taxation for local tax purposes.

The computation method of net capital gains for local tax purposes is the same method used for national income tax purposes.

For the local inhabitants tax on gains derived from the disposition of securities, it is not necessary to provide the name and address of the payee of sales proceeds and file a certificate of payment.

Local inhabitants tax does not apply to gains which are subject to separate taxation at a flat withholding tax rate (i.e. 1% of proceeds) for national income tax purposes.

The above revision applies to transactions on or after 1 April 1989.

4. Taxation of retirement allowance

The basic allowances for national tax also apply to local tax.

5. Special taxation of long-term capital gains derived from transfer of real property

Please refer to the explanation on national tax.

IV. CONSUMPTION TAX

The centrepiece of the tax reform legislation passed by the Diet on 24 December 1988 was a comprehensive indirect tax on goods and services commonly referred to as the "consumption tax". The Government published the Consumption Tax Law, the Cabinet Ordinance for Enforcement of the Consumption Tax Law and the Ministerial Regulation for Enforcement of the Consumption Tax Law on 30 December 1988. The new tax is imposed on consideration for transfer of most goods and services executed after 31 March 1989.

A. Overview

Under the consumption tax system, the tax rate for all taxable goods and services is 3%, unless otherwise provided. The consumption tax is payable at each transfer for consideration in the chain of production and distribution. Each transferor may claim credit for

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related consumption tax paid to its suppliers in computation of the tax payable to the tax office. In effect, this credit mechanism pushes the consumption tax forward through the production and distribution chain to the ultimate consumer. The ultimate consumer absorbs the consumption tax as part of the purchase price.

Illustration:

The consumption tax is computed as follows in ¥ (3% tax rate):

	Producer of raw materials	*Producer of finished goods*	*Wholesaler*	*Retailer*	*Consumer*
Selling price	20,000	50,000	70,000	100,000	Retail price 103,000
Consumption tax	(1) 600	(2) 1,500	(3) 2,100	(4) 3,000	
Consumption tax to be paid	(1) 600	(2)–(1) 900	(3)–(2) 600	(4)–(3) 900	Total 3,000

The consumption tax differs from the value added tax (VAT) adopted by countries in the European Community (EC) and other countries in that it does not require completion of cumbersome invoices to document the extent to which a company has increased a product's value. The consumption tax payable by each business enterprise is computed from the records in the account books of those involved rather than from invoices.

Certain goods and services such as medical treatment under the public medical insurance law, certain tuition fees, certain social welfare projects and a limited number of other items are treated as non-taxable goods and services. Food, including rice, is subject to taxation.

Sellers whose annual revenue for a base period (as defined) does not exceed ¥ 30 million are not liable for the tax. In calculating tax payable to the tax office, taxpayers with annual sales of ¥ 500 million or less in the base period may be able to follow a simplified procedure.

The consumption tax replaces certain currently effective national and local indirect taxes including the commodity tax, the transportation tax, the sugar consumption tax and the electricity tax.

The following is a summary of the newly introduced "consumption tax" system.

B. Object of taxation

The consumption tax is imposed on the transfer or leasing of property and provision of services which are (1) for consideration, (2) in Japan, and (3) by persons who are engaged in a business within Japan. It also applies to imported goods. The items exempt from the tax are very limited but will include the following:

- transfer and leasing of land;
- transfer of securities (bonds and shares);
- interest income from financial transactions, joint trust operation fees and insurance premiums;
- transfer of postage stamps, revenue stamps and coupon tickets for sundry goods and services;
- certain services by the national and local governments rendered in connection with registration of legal matters, licensing, etc.;
- certain services relating to medical treatment under public medical insurance law, tuition fees and certain social welfare projects.

It should be pointed out that taxpayers engaged in transfer of the above items cannot claim credit for the related consumption tax paid to their suppliers. Accordingly, those taxpayers must increase prices to consumers to maintain their profit.

To the contrary, the revenue from exports, international transportation and international communication are completely exempt from the consumption tax. Exporters can claim credit for the related consumption tax paid to their suppliers and receive tax refunds, if applicable. The export exemption is also applicable to services rendered to non-residents, with certain exceptions specifically described. The definition of "non-resident" is the same as that contained in the "Japan Foreign Trade and Foreign Exchange Control Law".

C. Taxpayer

Taxpayers are persons who are liable to pay consumption tax to the Government. The term does not include persons who bear the consumption tax through payment to their suppliers. Persons who are liable to pay consumption tax are persons, including corporations who are engaged in a business in Japan and have revenue from sale or lease of taxable property and/or from the taxable services within Japan, and persons who import taxable goods.

D. Tax base, tax rate and tax credit

The tax base for consumption tax purposes is revenue from taxable goods, services, etc. It is determined on an accrual basis rather than on a cash collection basis.

Sales returns, sales discounts or sales rebates attributable to sales of taxable goods, services, etc. are reflected by a credit to the applicable consumption tax base for the taxable period in which such returns, discounts, etc. take place. Bad debts attributable to the sale of taxable goods, services, etc. are also reflected in this manner.

The consumption tax rate is 3%. However, under a transitional measure, the consumption tax on automobiles (passenger cars) is 6% for automobiles sold before 1 April 1992.

A tax credit for the consumption tax which was included in the cost of purchased goods, services, etc. is available against the consumption tax payable on revenue for the same taxable period. Unless the purchased goods, services, etc. are items listed as exempt from the consumption tax, this tax credit is available regardless of whether the supplier of the purchased goods or services paid the consumption tax. Taxpayers are required to maintain accounting books to record

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certain details for each purchase and to keep invoices and/or bills for purchases to support a claim for the tax paid on purchases.

If a taxpayer has revenue from non-taxable goods, services, etc. which amount to more than 5% of total revenue, the amount of the tax credit must be reduced by the purchases allocable to non-taxable sales. The definition of revenue from non-taxable finance and securities transactions is contained in the Cabinet Ordinance for Enforcement of Consumption Tax. In general, revenue from the transfer of securities is 5% of the consideration received for the transfer. Revenue from exports is considered taxable for purposes of calculating the credit on purchases.

The reduction of non-taxable revenues may be determined by using either partial tracing or an averaging convention. These methods operate as follows:

1. Partial tracing

Identify the consumption tax included in purchased goods, services, etc. directly related to taxable and non-taxable revenue, respectively. Consumption tax which cannot be traced is indirectly allocated in proportion to revenue as defined. The portion of consumption tax on purchases so determined to be directly and indirectly related to taxable revenue is allowable as a credit. Subject to a prior agreement by the tax office, a taxpayer may select other factors (number of employees, floor space, etc.) as the basis for such an allocation.

2. Averaging

The consumption tax included in purchased goods, services, etc. is allocated based on the ratio of taxable revenue to total revenue of the taxpayer.

The consumption tax included in purchased goods, services, etc. which is attributable to the revenue from exports may be credited under either method.

E. Tax period

The tax period is a calendar year for a sole proprietorship. The tax period for a corporation is the corporation's fiscal year. The tax payment must be made by the taxpayer within 2 months after the close of the tax period with the return for the tax period. In principle, a provisional payment of the consumption tax will be required for a corporation whose tax period is one year. The required provisional payment will normally be computed as 50% of the actual tax paid for the preceding taxable period. If this amount is ¥ 300,000 or less, the taxpayer is not required to pay a provisional tax. Instead, the total tax for the entire taxable period may be paid when the final tax return is filed.

F. Special rules for small businesses

In order to reduce the burden in the payment of the consumption tax and other administrative work for small businesses, special rules have been provided as follows:

1. Exemption from tax

Individual and corporate business enterprises whose annual taxable revenue for the base period does not exceed ¥ 30 million will not be liable to pay the tax. In principle, the base period is the taxable period ending before the beginning of the preceding taxable period. As an example, the base period for 1992 would be 1990 for a calendar year taxpayer.

However, such businesses may become taxpayers at their own election. If so they are eligible to claim a credit for the consumption tax paid to their suppliers against the consumption tax calculated on their sales of taxable goods and services and, if applicable, receive a tax refund.

2. Reduction in tax

The consumption tax is reduced or eliminated for individual and corporate business enterprises whose annual taxable revenue for the current taxable period does not exceed ¥ 60 million (after deduction of the consumption tax on revenue in case the tax is included in annual revenue). These enterprises calculate the tax payable to the Government by applying the following formula:

$$\text{Tax payable} = \text{Tax otherwise payable (original tax due)} \times \frac{\text{Taxable annual revenue} - ¥\ 30\ \text{million}}{¥\ 30\ \text{million}}$$

3. Simple computation of tax liability

Individual and corporate business enterprises whose annual taxable revenue for the base period was ¥ 500 million or less can use a simplified formula to compute the taxes payable to the Government. At their option, these taxpayers may deem that the consumption tax included in the purchase of goods, services, etc. amounts to 80% (90% in the case of wholesalers) of the consumption tax calculated on their taxable revenue.

This special assumption results in a consumption tax payment of 0.6% of their taxable revenue (0.3% in the case of wholesalers), leaving the taxpayer free from keeping detailed records of purchased goods and services.

Taxpayers whose taxable revenue arising from wholesale business for the current taxable period is more than 50% of their total taxable revenue for the period generally qualify as wholesalers.

While the tax legislation concerning the Consumption Tax Law has been published, there are many areas which are not clearly prescribed in the legislation. Since the consumption tax, as introduced in Japan, is a unique and new tax, it will take several years for businessmen and consumers in Japan to familiarize themselves with the practices for dealing with the consumption tax.

The above outline of the consumption tax has been provided in a very general manner to facilitate an ease of overall understanding of its application and implications. It does not cover in detail intricacies of the new tax.

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JAPAN:

The Foreign Tax Credit System: Recent Amendments

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I. PREFACE

In Japan, non-resident individuals and foreign corporations are taxed only on their domestic-source income but resident individuals and domestic corporations are subject to tax on their world-wide income. Taxation on world-wide income necessitates measures to protect resident individuals and domestic corporations from being taxed twice. In the absence of such measures, income earned outside Japan might be taxed twice, i.e. once by the country of source and once by Japan, the country of residence.

In order to prevent double taxation, Japan introduced in 1953 foreign tax credit provisions in its corporate and individual income tax laws.[1] While the foreign tax credit system plays a key role in preventing double taxation, it should be noted that an extensive network of tax treaties between Japan and other countries (currently 36 countries) also plays a crucial role.

This article outlines the basic framework of the old foreign tax credit system in the Japanese corporate tax provisions, the reasons for the amendments to the provisions and the substance of the amendments themselves, as approved by the Diet on 30 December 1988.

II. BASIC FRAMEWORK OF THE OLD SYSTEM

A. Introduction

The foreign tax credit system under the Japanese corporate tax legislation can be divided into 3 systems.

1. Direct credit system

Under the direct credit system, foreign tax incurred by the taxpayer himself can be offset against Japanese tax, which is calculated using world-wide income as its tax base.

2. Indirect credit system

The indirect credit system allows a foreign tax credit with respect to underlying foreign taxes borne by domestic companies which have subsidiaries abroad. Usually dividends received by a domestic parent company from its foreign subsidiary are already taxed by the foreign country in the form of corporation tax on the subsidiary's profits. Without the indirect credit system, foreign tax levied on the earnings of the subsidiary may only be excluded from the tax base of the parent company. In such a case, Japanese companies might prefer to set up branches instead of subsidiaries abroad because they can enjoy a direct credit with regard to foreign tax levied on the branch income.

Under the indirect credit system, an amount corresponding to the dividends received is considered to be paid by the parent and the underlying foreign tax paid by the subsidiary may be credited against the Japanese tax of the parent company when it receives dividends. At the same time, the amount of indirect foreign tax credited is added back to the taxable income of the parent. Thus, through the indirect tax credit system, a foreign subsidiary is treated the same as a foreign branch.

3. Tax sparing credit system

The tax sparing credit grants foreign tax credit with respect to the amount of foreign tax "spared", i.e. the amount of tax relieved by a foreign country.

Many developing countries have introduced tax incentives in order to attract foreign investment. If the foreign tax incentive exempts Japanese investors from tax in that country, the investors are still taxed on world-wide income in Japan and the spared amount will only be transferred from the treasury of the developing country to that of Japan through smaller foreign tax credits allowed in Japan. The result is that no tax benefits remain in the hands of the investors. The tax sparing credit is designed to ensure that tax incentive schemes adopted by developing countries are effectuated by providing that Japan gives the company credit against its own tax for the tax which the company would have paid if the tax had not been spared.

1. Under the Japanese tax system, taxpayers can either choose to credit the amount of tax due in Japan by the amount of foreign tax incurred or deduct the amount of foreign tax from taxable income as expenses. The foreign tax credit is also allowed against local taxes on individual and corporate income.

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B. Creditable foreign taxes

1. Creditable direct foreign taxes

Creditable foreign taxes are taxes incurred directly by the taxpayer which are levied on corporate income by a foreign government and local authorities in accordance with tax laws, and which have the same characteristics as Japanese income tax, corporation tax and local income-based taxes. Thus foreign corporate tax on the income of foreign branches and foreign withholding tax on interest/dividends are creditable but foreign taxes which have the characteristics of penalties/royalties may not be credited.

2. Creditable indirect foreign tax

Underlying foreign tax with respect to dividends received by a Japanese company is creditable as an indirect foreign tax.[2] The creditable foreign tax[3] is computed as follows:

$$\text{Creditable foreign tax} = A \times \frac{\text{dividends received}}{B - A}$$

A = foreign tax imposed on the income of foreign subsidiary
B = income of the foreign subsidiary

3. Creditable tax "spared"

The scope of the tax incentives that enjoy the benefit of a tax sparing credit must be approved by Japan in a tax treaty between Japan and the country which provides the tax incentives. Creditable tax "spared" can either be a tax on business profits or a withholding tax on investment income, i.e. dividends, interest and royalties. It may be credited in the form of a direct tax credit or an indirect tax credit.

Japan recognizes the significance of tax sparing credits in supporting the purpose of tax incentives adopted by developing countries. However, the tax sparing mechanism has recently been the object of severe criticism in Japan. The main criticisms are as follows:

- it impairs the neutrality between foreign and domestic investment;
- it works as a subsidy primarily to large corporations and undermines the spirit of fair taxation; and
- broadening the scope of tax sparing credits contradicts the recent rationalization of special taxation measures in Japan.

Paying due respect to these criticisms, Japan wants to limit the scope of tax sparing credits to necessary and reasonable measures which are closely related to the economic developments of the benefiting countries.

C. Credit limitation

Since the purpose of allowing a tax credit to Japanese corporations is to eliminate double taxation on their foreign-source income, it is important to prevent the credit from spilling over into their Japanese-source income and reducing the Japanese tax on that income. Therefore limits are set on the amount of foreign tax that can actually be credited. Japan adopts the "overall limitation" under which all foreign-source income and foreign taxes are added up to calculate the limitation regardless of the items on which the foreign taxes are levied or countries in which the taxes are collected. The formula of the limitation is as follows:

$$\text{Foreign tax credit limitation} = \text{Amount of "calculated" Japanese tax} \times \frac{\text{foreign source income}}{\text{world-wide income}}$$

$$\text{Amount of "calculated" Japanese tax} = \text{world-wide income} \times \text{corporate tax rate}$$

D. Treatment of the remainder of credit limitation and the excess of foreign taxes

Under the foreign tax system, foreign taxes are recognized when they are paid while an accrual basis is used to calculate the credit limitation. However, this causes problems; cases might arise where foreign taxes cannot actually be credited because of a discrepancy in the timing of the payment of foreign taxes and the accrual of the corresponding foreign-source income. In order to cope with this problem, Japan allows the remainder of the credit limitation that is not actually used up as well as the excess of foreign taxes to be carried forward for 5 years.

III. REASONS FOR AMENDMENTS

A. Introduction

Certain problems were inherent in the previous foreign tax credit system. It has been pointed out that the former system was open to "excess utilization", i.e. utilization which went beyond its intended purpose of eliminating international double taxation.[4] Two of the problems of the system were the following:

- "Cross-crediting": foreign tax levied at a rate higher than the effective corporate tax rate in Japan could also be credited against Japanese tax.
- Income allocation: the ratio of foreign-source income to world-wide income did not reflect reality and the credit limitation was inflated.

B. Cross-crediting

As stated before, Japan adopts an "overall limitation" method to calculate the credit limitation. The merit of

2. The indirect foreign tax credit is permitted to a domestic corporation with respect to dividends received from foreign corporations provided that the domestic corporation owns, for a period not less than 6 months, at least 25% of the shares/voting shares of that foreign company.
3. Foreign tax imposed on foreign second and lower tier subsidiaries is not creditable.
4. An example often used to illustrate the "unjust" results of the system is that some large Japanese companies do not pay any tax in Japan. Even if these companies pay heavy tax abroad and even if their Japanese-source income is nil or negative, the public cannot understand how these large companies are actually not required to pay tax to Japan although their world-wide income contains a large surplus as a whole and they carry out large-scale operations in Japan, possess huge head office buildings and employ thousands of employees.

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this method is that it is simple to follow and administer.[5] However, the "overall limitation" method allows taxpayers to credit high foreign taxes paid on one stream of income not only against the Japanese tax with respect to that income but also against the Japanese tax due on other lightly taxed or exempted foreign income. Cross-crediting deviates from the system's original purpose of avoiding double taxation.[6]

Specifically, cross-crediting makes it possible to credit against Japanese taxes such foreign taxes as:

(a) foreign corporate taxes which are levied at a rate higher than the effective corporate tax rate in Japan;
(b) high rate withholding tax on interest since withholding tax on interest is a tax on the gross amount of interest. Even if the nominal tax rate is, for example, 20%, it is likely that the amount of withholding tax exceeds the amount of Japanese income tax imposed on the net basis income from that interest; and
(c) high rate indirect foreign tax – with respect to the dividends received from foreign subsidiaries, taxable income is the sum of dividends received and the indirect foreign tax that is added back, while foreign tax levied on that taxable income is the sum of indirect foreign tax and withholding tax on the gross amount of those dividends. Therefore, the actual tax burden with respect to the taxable dividend income received may well be heavier than the Japanese effective corporate tax rate.

Cross-crediting also relates to the problem of economic distortion, where companies will be tempted to do business in low tax or no tax countries mainly to create unused credit limitations which can be used to cross-credit the taxes of other high-tax countries.[7] A portfolio investment in a country with no tax may be particularly inviting. This impairs neutrality of investment.

C. Income allocation

One principle of the foreign tax credit system is that it should not reduce a taxpayer's Japanese tax on his Japanese-source income. For this reason, the amount of foreign tax creditable is limited to the amount of Japanese tax allocable to the taxpayer's foreign-source income. However, this limitation has no effect if proper allocation of income between Japanese source and foreign source is not realized. Padding foreign-source income, if possible, will increase the credit limitation and reduce the tax revenue of the tax revenue of the Japanese Government.

For example, suppose a Japanese company earns all of its income overseas. It will pay no Japanese tax provided that the average tax rate abroad is higher than the rate in Japan. However, this is difficult to accept if this company, for example, hires more than half of its employees in Japan. It is natural to claim that at least some portion of its income should be allocated to Japan.

In Japan, the ratio of income earned overseas to total world-wide income sometimes appears too high considering the operational practices of the company. Some of the causes can be summarized as follows:

- The present "source rule", which distinguishes between revenue accrued in Japan and revenue accrued outside Japan, proposes an "all or nothing" solution. For example, even if the head office expends substantial personnel costs to purchase goods that are to be sold through foreign branches or to make loans to other countries, all sales income or interest income related to these transactions are deemed to accrue outside Japan.
- Criteria used to allocate expenses to Japanese-source income and foreign-source income also suggest bold solutions. For example, losses from bad loans abroad and the bankruptcy of foreign subsidiaries are generally considered as expenses incurred by the head office in Japan (although interest and dividends from such subsidiaries are considered foreign-source income). In addition, interest expenses are usually allocated proportionately according to the value of assets in Japan and abroad.

Although the "source rule" for each category of income and the cost allocation rules for expenses are based on understandable reasoning, accumulation of all this income and expense sometimes shows an expansion of foreign-source income. The result of in-

5. The "overall limitation" method has the merit of simplicity in compliance and administration when allocating income. Allocating income would be more complicated if the "per-country limitation" or the "per-income limitation" method were applied.

6. For example, assume the rate of corporate tax in Countries A, B and Japan to be 65%, 15% and 45%, respectively. Japanese Company X earns income of ¥ 100 in Countries A and B but earns no income in Japan. With respect to the tax of ¥ 65 that Company X pays to Country A, Japan avoids double taxation by allowing a credit of ¥ 45. Up to this point, Company X would pay as tax ¥ 65 in Country A and nil (liable Japanese tax of ¥ 45 minus credit of ¥ 45) in Japan, and Company X's total tax burden would be ¥ 65, an amount Company X must be prepared to pay when it decides to do business in Country A.
However, owing to the fact that Company X also entered into business in Country B where taxes are low, Company X can credit the whole ¥ 65 against Japanese tax. This is done by "cross-crediting", i.e. diverting the residual credit limitation not used up in relation to Country B to Country A's foreign tax in excess of the credit limitation, i.e. Country A's tax of ¥ 20, which spilled over from the credit limitation created in relation to Country A can be credited against Country B's unused credit limitation of ¥ 30 (the difference between credit limitation of ¥ 45 and the tax of ¥ 15 actually paid to Country B).
The final amount of tax Company X has to pay to Countries A and B and Japan will be ¥ 65, ¥ 15 and ¥ 10 ("calculated" Japanese tax of ¥ 90 minus the sum of creditable foreign tax, ¥ 65 for Country A and ¥ 15 for Country B), respectively. However, if cross-crediting were not allowed, the amount of tax Company X would have to pay to Countries A, B and Japan, while not suffering from double taxation, would be ¥ 65, ¥ 15 and ¥ 30 (liable Japanese tax of ¥ 90 minus sum of foreign tax of ¥ 45 for Country A and ¥ 15 for Country B), respectively. Hence, in this example, cross-crediting reduces Company X's total tax burden by ¥ 20 and results in the Japanese Government's revenue loss.
The cross-crediting problem raised in this example will disappear if Japan adopts a "per country limitation" method which precludes cross-crediting between different countries.

7. Permitting the remainder of credit limitations not actually used up or the excess of creditable foreign taxes to be carried forward also results in a sort of cross-crediting between different business years.

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Classification by business		*Creditable amount for each withholding tax*
Companies whose main business is financial business, including securities business		
Average ratio of net taxable income to total revenue in the business year concerned and the 2 preceding years	10 % and less	up to 10% of the interest received
	20% and less	15% of the interest received
	more than 20%	full amount
Other companies whose ratio of interest revenue to the sum of interest revenue and gross profit is more than 20%		
Average ratio of net taxable income to the sum of gross profit and non-operating revenue in the business year concerned and the 2 preceding years ("profitability")	10% and less	up to 10% of the interest received
	20% and less	15% of the interest received
	more than 20%	full amount

come allocation should somehow reflect such factors as the contribution made by the head office, the ratio of the number of employees working in Japan or the number of transactions the head office is involved in.

IV. AMENDMENTS

A. Introduction

To address the problems described above, the Japanese Government proposed amendments to the foreign tax credit system as a part of the overall tax reform. These amendments received Diet approval in December 1988. They apply to business years beginning on and after 1 April 1989, unless otherwise provided. The contents of the amendments are outlined below.

B. Calculation of the credit limitation

50% of income exempted from taxation in foreign countries is to be excluded from foreign-source income in calculating the credit limitation (see above for the formula). This amendment is designed to reduce the amount of credit limitation that can be created by investing in tax-exempt countries and to curtail cross-crediting. The 50% exclusion[8], instead of the 100% exclusion of exempted foreign income, represents a compromise to balance exempted income[9] and very lightly taxed income. An upper limit of 90% is established for the ratio of foreign-source income to world-wide income in calculating the credit limitation. This amendment responds to the problem of income allocation. With this restriction, Japanese tax corresponding to a minimum of 10% of the total income must be paid in Japan.[10]

C. The scope of creditable foreign taxes

1. General rule

The amount of foreign tax corresponding to the amount by which the tax amount exceeds 50% of the tax base in the foreign country is no longer eligible for the foreign tax credit, but can only be deducted from income as expenses. This amendment reduces the amount of tax that spills over from the credit limitation on that source and decreases the possibility of cross-crediting.[11]

2. Foreign withholding tax with respect to interest

In order to restrain high rate withholding tax from being cross-credited against taxes from other sources, a limit is placed on the eligible amount of foreign

8. A 33.3% exclusion will be applied as a transitional measure for the first 2 business years beginning on and after 1 April 1989.
9. Exempted income corresponding to the taxes "spared", i.e. deemed to be paid according to the tax treaties, shall not be treated as "income exempted from taxation in foreign countries".
10. Exceptions will be granted to companies which are subject to very severe foreign tax burdens amounting to, as a whole, more than 50% of total world-wide income and to companies with more than 90% of their employees working overseas. For these companies, the ratio of foreign-source income to world-wide income may be higher than 90%.
11. The effective corporate tax rate in Japan is regarded to be a little less

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withholding tax (including taxes "spared") which is levied on the gross amount of interest (see table above). The rest of the withholding tax (except "spared" tax) will be deducted from income as expenses.[12]

3. Foreign tax with respect to dividends

The amount of foreign taxes on dividends eligible for the indirect foreign tax credit is now limited to the amount calculated by the formula below, provided that this amount is smaller than the amount computed by using indirect tax formula above. The formula is as follows:

$A = B - 2 \times C$

A = limitation of creditable indirect tax
B = dividends received (including withholding tax)
C = foreign withholding tax on dividends[13]

D. "Carry-forward" period of the remainder of the credit limitation and the excess creditable foreign taxes

The length of the period that the remainder of the credit limitation and the excess creditable foreign taxes can be carried forward is shortened from 5 years to 3 years. The purpose of this amendment is to restrict cross-crediting between years.

E. Allocation of expenses

Rules for allocation of expenses such as interest expenses to foreign and domestic-source income, which are provided in the administrative guidances and measures, will be reviewed to respond to the problems related to income allocation.

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than 50%, including local taxes on corporate income.

12. Whether a particular withholding tax rate on interest is too high is judged in relation to the "profitability" of the company. For example, suppose the profitability of a company is 10%. It is not illogical to estimate that profitability with respect to particular interest received is also 10%. Japanese corporate tax will be about 50% of the net profit or 5% of the interest revenue. Granting a 5% allowance, it is considered that a withholding tax corresponding to a rate in excess of 10% of the interest is too high. Hence, the amendment prohibits the amount of withholding tax corresponding to the rate in excess of 10% from being credited against Japanese tax.
Withholding taxes on interest concerning loan arrangements concluded or securities issued prior to the first date of the first business year beginning on and after 1 April 1989 will not be subject to the newly introduced restrictions for the first 5 business years from that date. Withholding tax on interest from loan arrangements concluded or securities issued in the business years beginning on and after 1 April 1989 will be subject to the new regulations from the outset.

13. This formula is obtained by resolving the following equation in which the sum of the creditable indirect tax and the withholding tax is equal to 50% (effective corporate tax rate in Japan) of the income subject to Japanese corporate tax, i.e. sum of the dividend income and the creditable indirect tax.

$A + C = 50\% \times (B + A)$
$A = \frac{1}{2}(B + A) - C$
$A = B - 2C$

IFA NEWS

BRITISH BRANCH

The British Branch distributed the minutes of their annual general meeting of 20 June 1989. Highlights are:

- The number of members increased from 531 to 551.
- The technical meetings were well attended. One meeting dealt with a foreign country (Japan) and another was on the European tax harmonization. The other eight meetings were on international tax aspects of United Kingdom taxation and general international tax matters. A programme of 6 meetings was organized by the Manchester Branch.
- On 9 and 10 September 1988 a joint seminar was held by the British and Canadian Branches which was attended by 110 persons.
- Mr. John Avery Jones (Speechly Bircham) took over the Chairmanship from Mr. David Davidson. Mr. J.S. Phillips and Ms. Barbara Roberts (Honorary Treasurer and Assistant Honorary Treasurer, respectively) were replaced by Mr. John Fairley and Mr. Noel Davidson (both of Ernst & Young).
- The Branch elected Messrs. D.F.A. Davidson, J. Fairley, J.S. Phillips, G.D. Swaine, D.G. Tapper and D. Keel as members of its Committee.
- Arrangements for a joint seminar with the U.S.A. Branch were finalized.

The British Branch also distributed its programme for 1989-90:

- 12 October 1989: Discussion of the national reports for the Annual Congress of IFA in 1990 in Stockholm;
- 23 October 1989: Talks on reorganizing multinational groups;
- 16 November 1989: Meeting on Spain and Portugal;
- 6 December 1989: Talks on the international aspects of inheritance tax planning and double taxation treaties;
- 23 January 1990: Talk on the tax implications of European Economic Interest Groupings;
- 13 February 1990: Talk on intercompany transfer pricing in the United States and the implications of the U.S. White Paper;
- 24 April 1990: Discussion of recent tax cases;

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AUSTRALIA:

An Overview of Research and Development Incentives

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INTRODUCTION

Despite its recent bicentennial celebration Australia is a young country in the scheme of global affairs. It has gone the route of many other countries in its development from a pastoral society to the modern free enterprise economy. As a part of its overall strategy to encourage the development of domestic manufacturing and tertiary industry, governments of the day have over the years adopted a variety of methods such as import tariffs, subsidies and other incentives to promote growth in these sectors.

The aim of this article is to highlight methods which are currently adopted to promote growth in one particular area – industrial research and development – the encouragement of which is expected to generate significant long-term benefits for Australian industry.

Incentives are provided in the form of direct financial grants and generous tax write-offs for expenditure incurred on research and development (R & D) and for plant, equipment and buildings used for such research.

Overall responsibility for the control of R & D rests with the Industry Research and Development Board ("the Board").

Industry Research and Development Board

The Board was established under the Industry Research and Development Act 1986 (IRDA) whose object is to promote the development and improve the efficiency and industrial competitiveness of Australian industry by the provision of financial assistance for R & D activities.

The Board has powers to give grants directly to qualifying companies for the purpose of carrying on R & D activities. In addition, it has the responsibility for certifying to the Commissioner of Taxation that a company's activities in the field of R & D qualify it for the tax concessions available, specifically in relation to Sec. 73B of the Income Tax Assessment Act 1936 (ITAA).

To be eligible under the IRDA the person, company or institution (the researcher) must be carrying out R & D activities. These are defined in the IRDA and the ITAA as being:

Systematic investigation or experimentation activities –
(a) that involve innovation, technology transfer into Australia or technical risk;
(b) that are carried out in Australia; and
(c) the object of which is new knowledge (with or without a specific practical application) or new or improved materials, products, devices, processes or services.

The Board itself is mainly concerned with the following grants or agreements:
(a) Discretionary grants
(b) Generic technology grants
(c) National interest agreement payments

As the IRDA is presently structured, the Board is limited by the fact that it may not enter any agreements after 30 June 1991 nor make a grant in respect of any project commencing after that date. This position is under review given the recent extension to the R&D accelerated deductions.

(a) Discretionary grants (Sec. 28)

These are available to companies which apply for them and which are carrying out or proposing to carry out an eligible activity in Australia. An "eligible activity" is defined in Sec. 4(1):
(i) the manufacture of goods;
(ii) mining operations or operations for the recovery of naturally occurring petroleum or natural gas;
(iii) construction operations relating to buildings or works;
(iv) the production of software for computers or similar equipment;
(v) any activity which the Minister has declared to be an eligible activity under Sec. 26 of the IRDA;
(vi) the development of systems and processes in relation to one of the activities referred to in (i) to (v) above.

Any grant will be limited to an amount not exceeding 50% of the total expenditure which, in the opinion of the Board, is or will be incurred in respect of the project forming the object of the grant (Sec. 29(2)).

(b) Generic technology grants (Sec. 31)

These grants are available for collaborative R & D between businesses or researchers and Approved Research Institutes (ARI). Generic technology grants enable support to be given to new and emerging hi-technology but limited at present to the fields of

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biotechnology, new materials, information technology and communications technology. The Minister is, however, empowered to declare, by notice in writing in the Gazette that any area of technology is an area of generic technology (Sec. 30 (1)).

The applicant must be involved in R & D in one of these particular fields in collaboration with an ARI and have a proven record of achievement or a substantial prospect of success in the field.

The researcher[1] must apply for a grant of this type, and unlike discretionary grants, generic technology grants are not limited to companies. The benefits are made available to researchers. A successful applicant for a generic technology grant is eligible for a grant of up to 90% of salaries, direct costs and consumables relating to approved activities for up to 3 years. Experience indicates flat that the success rate for applicants who satisfy the criteria outlined is better than that for discretionary grants, i.e. in excess of 50% chance of success.

(c) National interest agreement payments (Sec. 33)

These differ from the first 2 grants discussed above in that they can arise either out of a determination by the Commonwealth that a particular project of R & D should be undertaken, or by way of an application from a researcher involved in a project which he feels is of national importance.

These agreements provide that the Commonwealth will fund all or part of the expenditure on the project. Where it funds the entire cost, ownership of all incorporeal property (patents, copyright, designs, etc.) will vest in the Commonwealth and where it funds a portion of the cost then ownership of an appropriate proportion of that incorporeal property will vest in the Commonwealth (Sec. 34(1)).

Certain general matters are applicable in all instances where grants or subsidies have been paid.

(i) *Exploitation*

Before the Board will enter any of these agreements or pay any grant as subsidy it must be satisfied that the results of the project will, in appropriate instances, be exploited on normal commercial terms in a manner that will be for the benefit of the Australian economy.

(ii) *Variation of grants*

Where a researcher receives financial assistance from other sources which has helped him to carry out a project which is subject to an agreement under the IRDA, the Board is entitled, but not compelled, to reduce the grant by such amount as it deems fit.

(iii) *Repayment*

Repayment of any amounts may be required should a researcher breach his contract with the Board.

Penalties

Penalties may apply where a person knowingly obtains or attempts to obtain, for himself or another person, a subsidy to which he or that other person is not entitled.

Tax concessions

Until 1 July 1985 grants had been the generally accepted method of funding R & D activities. On 1 July 1985 the Government introduced an expanded tax benefit for any R & D carried on in the field of either pure or applied research.

The tax concession introduced from 1 July 1985 is contained in Sec. 73B of the ITAA and allows for R & D expenditure to be deducted from assessable income at the rate of 150% in the year in which it is incurred. Prior to this concession, capital expenditure on R & D was deductible from assessable income at the rate of 100%, but only if the research was related to the type of business already being undertaken by the company.

The ITAA provides 2 major classes of concessions for R & D development which form the cornerstone of the Government's strategy to encourage R & D.

First it allows for the writing off by investors of their investments in a particular type of venture capital company known as a Management Investment Company. Secondly it allows for the writing off of amounts in excess of actual expenditure incurred for R & D together with accelerated depreciation write-offs for plant and equipment (Sec. 73A and 73B of the ITAA).

Management and investment companies

Management and investment companies (MICs) are companies set up under the Management and Investment Companies Act (MICA) 1983 with the intention of fostering investment in high technology industries.

Subject to certain qualifications, an investor is entitled under Sec. 77F of the ITAA to write off any moneys paid by him in respect of equity subscriptions such as application and allotment moneys, calls and share premiums. The investor must be one of the initial subscribers and the MIC must be licensed. Payments made before a licence is granted will, however, be eligible if the MIC Licensing Board considers that the subscription was made in anticipation of, or to ensure that the company would be eligible for, the grant of a licence.

Shares in MICs for which a deduction has been allowed must not be disposed of within 4 years of acquisition otherwise all or a portion of the deduction will be disallowed under Sec. 77F(5) as follows:

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1. A researcher is defined as:
a person who, or a body, an organisation or an institution, that, ..., is capable of carrying out a project of research and development activities and, ..., includes a department of state, a company and an approved research institute.

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(a) Where the shares are disposed of within 2 years of acquisition the deduction will be disallowed in full.
(b) Where the disposal occurs more than 2 years but less than 3 years after acquisition 50% of the deduction will be disallowed.
(c) Where the disposal occurs more than 3 years but less than 4 years after acquisition 25% of the deduction will be disallowed.

Disposal of the shares includes not only an actual alienation of them by the holders but also a deemed disposal where, for example, the company itself redeems, cancels or pays off a portion of the shares as part of a capital reduction or where the shares are forfeited for non-payment of any call on partly paid shares.

The 4-year period runs, not from the date of issue of the shares, but from the date on which the last payment in respect of them was made. Thus, where partly paid shares are subject to calls, the 2 years will run from the date of the latest call.

Proceeds of shares sold after being held for the requisite 4-year period are unlikely to attract tax under Sec. 25(1) or Sec. 25A of the ITAA as, according to the Treasurer in answers given to a parliamentary question, they are regarded as having been made as a genuine capital investment.

Any profits made on shares acquired prior to 20 September 1985 would then be free of all tax whilst those acquired after that date would be subject to the capital gains provisions of the ITAA.

Expenditure on research and development

Secs. 73B and 73A overlap to an extent and the Treasurer has announced that, subject to certain amendments to be made to Sec. 73B effective 30 June 1995, expenditure after that date will not be deductible under Sec. 73A but under Sec. 73B. Thus, whilst not being repealed, Sec. 73A will eventually fall into disuse.

Sec. 73A is applicable to expenditure by "a person" which, as defined in the ITAA, will include a company whereas Sec. 73B relates only to expenditure by companies, partnerships of companies and public trading trusts. Further amendments to the concession have been announced to take effect when Sec. 73B replaces Sec. 73A after 30 June 1995.

Sec. 73A allows a deduction for capital expenditure other than plant and equipment and buildings. Sec. 73B is all encompassing and makes no distinction between revenue and capital expenses.

The deduction under Sec. 73A is limited to expenditure incurred in respect of scientific research related to a particular business or class of business while Sec. 73B refers to expenditure on a broader class of R & D which is not limited to scientific research.

Sec. 73A

In broad outline Sec. 73A provides for the following:
(a) Payments to approved research institutes or for otherwise non-deductible capital expenditure for scientific research are allowable deductions at the rate of 100%.
(b) A write-off over 3 years for expenditure on buildings used exclusively for scientific research.
(c) Plant used exclusively for scientific research may be depreciated at 33⅓% per annum on the prime cost basis or 50% per annum on the diminishing value basis.

Before any further analysis of Sec. 73A, it is necessary to consider the definition of some relevant expressions and phrases which appear in it.

Sec. 73A(6) contains the following definitions:
"an approved research institute" means the Commonwealth Scientific and Industrial Research Organisation, or any university, college, institute, association or organization which is approved .... by that Organisation, by the Secretary to the Department of Health, by the Secretary to the Department of Science or by the Secretary to the Department of Employment and Industrial Relations, as an institution .... for undertaking scientific research which is or may prove to be of value to Australia.

"Scientific research" means any activities in the fields of natural or applied science for the extension of knowledge.

Sec. 73A(8) provides that any reference to scientific research in relation to a business or class of business includes any scientific research which leads to an extension of the business or its technical efficiency and also includes any scientific research of a medical nature which specially relates to the welfare of workers in that business or class of business.

(a) Current expenditure

Sec. 73A(1) provides that expenditure in the form of payments to an approved research institute for scientific research related to a business or class of business, as well as other capital expenditure on scientific research, other than any expenditure on plant or buildings, will be deductible.

Deductions under this sub-section are conditional on the fact that the deduction would not otherwise be deductible under any other section of the ITAA and that the person claiming the deduction is carrying on a business of the kind to which the research relates.

This concession allows for the immediate deduction of expenditure which would not otherwise have qualified or which, in the case of capital expenditure, might in appropriate circumstances have qualified for a write-off over a longer term in the form of depreciation.

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(b) Building expenditure

(i) *Deduction*

Sec. 73A(2)-(2A) deals with the deduction of expenditure on the acquisition, construction or alteration of any building to be used for scientific research in the business carried on by the taxpayer.

The capital cost incurred may be written off in 3 equal instalments, commencing in the year in which the building is first used for scientific research and in the following 2 years provided the business is continued.

This concession is limited by the proviso that acquisition, etc. must have taken place before 21 November 1987, or in terms of a contract entered into before that date. In addition, where expenditure is incurred after 21 November 1987 the taxpayer must show that scientific research would be carried out in the building by him or on his behalf and that the building would be used for scientific research purposes only.

(ii) *Recoupment of deduction*

If a building, in respect of which a deduction has been allowed under this section, is disposed of or destroyed, then any consideration or compensation received by the taxpayer will be assessable to the extent of any deduction previously received.

(c) Plant and equipment (plant)

Plant which qualifies for depreciation elsewhere in the ITAA is specifically made depreciable at rates of 33⅓% if the prime cost method is used or 50% under the diminishing value method.

None of the other concessional depreciation rates such as the loading or accelerated rates apply when a deduction is claimed under Sec. 73A.

All the other provisions which normally relate to depreciable assets such as balancing charges on disposal are applicable to plant depreciated in terms of Sec. 73A.

General

The underlying aim of all the concessions is to promote scientific research in Australia. Thus Sec. 73A(3) provides that where a portion of the expenditure on or part of the business, in respect of which the scientific expenditure is incurred, takes place outside Australia, the Commissioner of Taxation has discretion to allow only such proportion of the expenditure as he considers to be reasonable in the circumstances to be deducted.

As was indicated earlier, the provisions of Sec. 73A are likely to become redundant after 30 June 1995 with only a run-off in respect of building and plant allowances where these assets were bought into use before the effective date.

Sec. 73B will thus become the main provision by which tax concessions are utilized to encourage R & D.

Sec. 73B

Sec. 73B allows a company to write off certain expenditure which either would not have qualified as an allowable deduction, or if it did, at a lower rate of deduction than allowed by the section.

Sec. 73B applies to expenditure incurred on or after 1 July 1985 but not later than 30 June 1998.

Because of the differences between this section and Sec. 73A, a number of terms used in Sec. 73B should be defined at the outset.

"Research and development activities" means:
(a) systematic, investigative or experimental activities that:
  (i) are carried on in Australia or in an external Territory;
  (ii) involve innovation or technical risk; and
  (iii) are carried on for the purpose
    (A) of acquiring new knowledge (whether or not that knowledge will have a specific practical application); or
    (B) creating new or improved materials, products, devices, processes or services; or
(b) other activities that:
  (i) are carried on in Australia or in an external Territory; and
  (ii) are carried on for a purpose directly related to the carrying on of activities of the kind referred to in para. (a).

"Research and development expenditure" means expenditure incurred by the company during the year of income, being:
(a) contracted expenditure of the company;
(b) salary expenditure of the company, being expenditure incurred during the deduction period;
(c) other expenditure incurred during the deduction period directly in respect of R & D activities carried on by or on behalf of the company during the deduction period.

Sec. 73B(2) specifically excludes the following activities from the ambit of the R & D definition:
(a) market research, market testing or market development or sales promotion (including consumer surveys);
(b) quality control;
(c) prospecting, exploring or drilling for minerals, petroleum or natural gas for the purpose of determining the size or quality of any deposits;
(d) the making of cosmetic modifications or stylistic changes to products, processes or production methods;
(e) management studies or efficiency surveys;
(f) research in social science, arts or humanities;
(g) the making of donations.

Similarly, expenditure on developing computer software will not be considered to be R & D activities unless the software is being developed for sale, rent, licence, hire or lease to at least 2 non-associates of the company.

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In outline, the concessions under Sec. 73B are the following:
(i) deduction of up to 150% of R & D expenditure in the year in which it takes place;
(ii) plant and equipment used exclusively for R & D activities is deductible up to 150% of its cost over 3 years;
(iii) the cost of buildings used exclusively for R & D activities can be written off over 3 years. (This provision has been amended as will be seen in the detailed discussion on this point later in the article.)

Qualifying expenditure

In order to obtain the maximum write-offs of 150% available in respect of R & D and plant expenditure, it is necessary for the company to have incurred a minimum expenditure in the year. This amount is called the "aggregate R & D amount".

Where the aggregate R & D amount is less than A$ 20,000, Sec. 73B does not apply. Where the aggregate R & D amount is A$ 50,000 or more, the full 150% concession is applicable.

For amounts between A$ 20,000 and A$ 50,000 of aggregate R & D amount, the write-off is on a sliding scale based on a defined formula, e.g. where the aggregate amount is A$ 25,000, the relevant percentage write-off is 117% whilst at A$ 40,000 it is 142.0%. The aggregate R & D amount is calculated by taking the sum of the following amounts:
(i) actual R & D expenditure (including contracted expenditure) for the year;
(ii) one third of the qualifying plant expenditure for the year;
(iii) one third of the qualifying building expenditure for the year.

There is, however, no threshold requirement for contracted expenditure, i.e. expenditure incurred in having a registered research agency, an approved research institute, or the Coal Research Trust carry-on research on the company's behalf. Expenditure of this nature is always deductible at a rate of 150% in the year in which it is incurred. Actual expenditure on contracted research is taken into account when computing the aggregate R & D amount.

The Government has recently announced that the 150% deduction will be available for eligible expenditure incurred prior to 1 July 1993; in the period to 1 July 1995, a deduction of 125% will be available.

Having established the level at which deductions can be claimed it is now necessary to look at what may be claimed.

1. Research and development expenditure

The definition of R & D expenditure was set out earlier but it is necessary to look more closely at the elements of the definition.

(a) *Contracted expenditure*

This comprises payments to one of the following bodies for conducting research on behalf of the company:
(i) The Coal Research Trust;
(ii) A Registered Research Institute (until 30 June 1988);
(iii) A Registered Research Agency (RRA) (from 20 November 1987).

An approved research institute is as defined in Sec. 73A. Whilst the terminology has changed to RRA from 20 November 1987, most existing institutes would, however, meet the requirements to be registered as a research agency.

RRAs are a much wider category than the approved research institutes and can be privately owned profit-making entities.

Requirements for registration of such an agency are set out in the IRDA which provides that any body of persons corporate or unincorporate can apply to the "Board" for registration as a research agency.

Payments made to an agency by any company will, however, only qualify as contracted expenditure where:
- the agency is not an associate of the company;
- the company requesting the research was capable of utilizing the results of the agency's R & D;
- the company is entitled to receive the results of the R & D carried out by the agency since the R & D must by definition be carried out on behalf of the company.

(b) *Salary expenditure*

The salaries of all persons directly engaged in R & D activities may be claimed. Salary expenditure is widely defined in Sec. 73B(1) and includes a proportionate share of the salary expenses of those employees only partially engaged in R & D activities. Fringe benefits payments are not included within the definition of salary.

The company must keep sufficiently detailed records to enable it to substantiate any claim for the concessional deduction by reference to, for example, time sheets or job cards.

(c) *Other expenditure*

No definition of this item appears in the ITAA and no attempt will be made to define it in this article. Such expenditure must pass the directly related test to qualify as part of R & D activities. International cost sharing arrangements do not as such qualify as the benefit of the research is not predominantly Australian. Local collaborative research is not predominantly Australian. Local collaborative research arrangements are possible. Syndication of eligible projects is also expressly provided for in the Act.

Sufficient records must be kept to enable the company to substantiate the expenditure, its connection with

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the company's R & D activities and any basis of apportionment adopted.

2. Plant expenditure

Expenditure by a company in acquiring or constructing a plant to be used exclusively for R & D will qualify for a write-off of 150% of that expenditure over 3 years, beginning in the year in which the company commences to use the plant and in the following 2 years.

In order to qualify for the full 150%, the company must have an aggregate R & D amount of A$ 50,000 or more as discussed earlier. Where the amount is between A$ 20,000 and A$ 50,000, a write-off of between 100% and 150% as calculated by a set formula will be allowable.

The write-off for any year must be recalculated each year in the light of that year's aggregate R & D amount.

The section places no ceiling on the value of the plant that may be written off under the concession provided that it is used for R & D purposes exclusively. Where, however, the plant is deemed to be a pilot plant, there is a limit of A$ 10 million on the qualifying amount.

"Pilot plant" is defined in Sec. 73B(1) as meaning an experimental model of plant for use in R & D activities or for use in commercial production, being a model that is not for use in commercial production but that has the essential characteristics of the plant of which it is a model.

Any excess of the expenditure on the plant over A$ 10 million may be written off at normal depreciation rates over its useful life but commencing only after the expiry of the 3 years during which the initial A$ 10 million is written off.

The company is not, however, obliged to claim under Sec. 73B and may elect to depreciate the plant, whether the plant is a pilot plant or any other plant, in the normal manner as allowed under the ITAA. Notice of such an election must be given on or before lodgement of the first return of income in which the company would have made a claim under Sec. 73B in respect of an item of the plant.

Where the plant, which has been the subject of an allowance under this section, is disposed of, lost or destroyed, balancing adjustments must be made.

Where the consideration received is less than the written down value the "loss" is multiplied by the applicable concessional rate so that the company receives the full benefit of the concession to the date of disposal.

The Treasurer has announced that the special deduction for the plant will cease in respect of expenditure incurred after 30 June 1995. From that point in time expenditure of this nature will only be deductible in accordance with rates specified in the general depreciation schedule for a plant of that type.

An R & D plant must be exclusively used in R & D for the full year in which a claim is made.

3. Building expenditure

Sec. 73 B(4) provides that expenditure on acquiring, constructing, altering or extending a building to be used exclusively for R & D purposes during the deduction period qualifies for a deduction over a 3-year period commencing in the year in which the building is first used.

The building may be owned or leased by the company. In order to qualify for the full benefit of the concession, it must have been acquired or construction must have begun prior to 20 November 1987. Where it is actually acquired or construction begins after that date, the contract for the acquisition or construction must have been entered into prior to that date. In this latter instance no allowance for expenditure incurred after 20 November 1987 will be allowed unless the company intended that the building should be used exclusively for the carrying on of R & D activities.

Subsequently, in the mini-budget speech it was announced that expenditure of this nature incurred after 20 November 1987 would qualify for an annual write-off of 2½% in line with existing provisions of the ITAA for deductions in respect of income producing buildings.

The concession continues to apply in respect of expenditure incurred prior to 20 November 1987 and the effects of any disposal, destruction or change of use of the building in question must be considered.

General provisions of Sec. 73B

(a) The section allows a deduction to a company only where the R & D is carried out by the company or on the company's behalf in Australia or one of its Territories.

(b) Ownership or development rights to results of R & D activities must rest in the company claiming the deduction. Effective ownership does not require legal ownership but it does require some measure of control of the commercial use of the results.

Where arrangements are such that the researcher company has in substance abdicated its ownership or control, the inference can be drawn that the R & D was being carried out on behalf of another person and will be deductible to the company paying for and exploiting the R & D results, rather than the company performing the R & D.

(c) Sec. 73B(8) provides that where any grant is received from a State or the Commonwealth or the company is entitled to be reimbursed to any extent in respect of any R & D project, such project shall not qualify for any deductions under this section. This provision is irrespective of how small or large a payment is received in respect of that project.

This provision is also to be amended to allow for a deduction in the event of assistance of this nature. The deduction will, however, be reduced by a factor which exactly negates the effect of the assistance.

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(d) Where the Board issues a certificate to the Commissioner under Sec. 39M of the IRDA certifying that it considers that the results of the R & D activities have not been exploited on normal commercial terms or for the benefit of the Australian economy, deductions will not be allowable (Sec. 73B(33)).

Such a certificate may also be issued where the Board considers that the R & D activities do not have sufficient Australian content.

(e) The Board also has powers to require a company to furnish it with such information as to its activities as the Board may require. Failure to do so can result in the disallowance of the deductions made under Sec. 73B.

(f) A pre-requisite for any deduction under Sec. 73B is that the company registers with the Board and complies with any requirements set by that body.

Application for registration must be made to the Board at the same time as the company lodges its tax return and a copy of the application must accompany the tax return.

(g) Where a company makes a false or misleading claim for a deduction it subjects itself to all the normal consequences of such an action under the ITAA and may find itself liable to penalty taxes and/or prosecution for an offence.

CONCLUSION

The question of R & D incentives is complex and this article has not sought to be an exhaustive exposition of the situation. Rather it has attempted to give a fairly broad overview of the position as it now stands.

The emphasis of Government assistance has clearly shifted from the grant system to a system of tax incentives, encouraging industry to innovate and incorporate R & D activities as an ongoing part of the business.

The concession offered as part of the tax system encourages Australian-based R & D to be exploited for the benefit of the Australian economy. The incentives offered by Sec. 73B are the cornerstone of the Government's strategy to increase the current level of R & D being undertaken in Australia, and it is hoped that this will be achieved by 30 June 1993, at which stage the benefit will drop from a 150% tax deduction to a 125% rate to 30 June 1995 before phasing to 100% tax deductibility.

Generally the industry has been encouraged by the financial incentive of increased tax deductibility for R & D expenses. The grant system has, however, remained in place. Discretionary grants are now aimed at small "start up" companies and companies in a tax "loss" situation which would not obtain a full or immediate benefit from an increased tax deduction. In this manner the Government is seeking to reward, encourage and subsidize R & D at all levels of industry. It enables the industry to look forward and compete at an international level.

Conference Diary

NOVEMBER 1989

I.T.P.A. Seminar. Palm Beach, 20-21 November (English):
Ms. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 65Z, United Kingdom.

Informations- und Aussprachetagung. Zürich, 21 November (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach, CH-8022 Zürich, Switzerland.

Second IFA Regional Congress: Hong Kong, 22-24 November (English):
Hong Kong Branch of IFA, c/o Group Tax Department, Hongkong Bank Group, GPO Box 64, Hong Kong.

The 6th Asian-Pacific Tax Conference: Europe 1992 – How will it affect investment and taxation in the Asian-Pacific region? Singapore, 27-28 November (English):
Asian-Pacific Tax and Investment Research Centre (APTIRC), 2 Nassim Road, Singapore 1025.

Oort en de Brede Herwaardering. Amsterdam, 27 November (Dutch):
Studiecentrum voor Internationaal Management, World Trade Center, Strawinskylaan 331, 1077 XX Amsterdam, The Netherlands.

Selling to the Soviet Market – Doing Business at a Time of Change. Vienna, 28-30 November (English):
Business International Limited, 40 Duke Street, London W1A 1DW, United Kingdom.

The Channel Islands. Guernsey, 29-30 November (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

DECEMBER 1989

Fundamental Elements of U.S. Federal Taxation. U.S. / International Taxation: Tax Strategies for Cross Border Activities; U.S. Taxation: Oil and Gas – Including International Aspects. United Kingdom, 4-9 December (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, U.K. Telephone (1) 935 7502, telefax (1) 935 1308.

Expatriating Abroad – The Tax and Financial Implications. London, 4 December (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Corporate Tax Planning for Operations outside Europe. London, 4 December (English):
Quorum Training Ltd., Tavistock House, Tavistock Square, London WC1H 9TW, United Kingdom.

VAT and the Banking Industry. London, 7 December (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

Taxation of Branches and Subsidiaries. Brussels, 7-8 December (English)
Management Centre Europe, rue Caroly 15, B-1040 Brussels (Belgium).

EC 1992: A Single Market. Implications for Tax Executives and their Companies. Washington, 10-12 December (English):
Tax Executive Institute, Inc., 1001 Pennsylvania Avenue, NW, Suite 320, Washington, D.C. 10004-2505, U.S.A.

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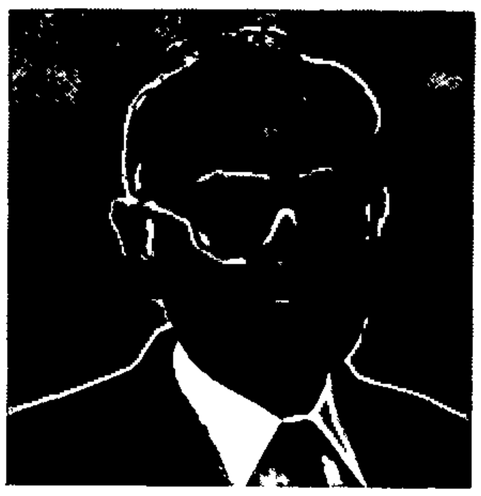

Continuance of Companies under the Malta International Business Activities Act 1988

Edwin A. Vella

INTRODUCTION

Company law in Malta is modelled on that of the United Kingdom and its principles are therefore embodied in the law and practice of that country. One established principle of U.K. company law is that the domicile of a company is the country of its registration and that the company retains this domicile throughout its existence: "...the domicile of origin clings to it throughout its existence".[1] Although this principle has apparently never been tested in the Maltese courts, it appears always to have been applied automatically.

This article considers the way in which the Malta International Business Activities Act 1988 (MIBAA) removes the obstacle presented by this approach to the mobility of offshore companies in a Maltese context. Before turning to this topic, it may perhaps be useful to take a brief look at MIBAA itself and in particular at what the Act means by an "offshore company" and the taxation treatment it affords to such companies.

MALTA INTERNATIONAL BUSINESS ACTIVITIES ACT 1988

MIBAA, which was passed on 2 November 1988, established the Malta International Business Authority, a body whose function is essentially to promote Malta as a centre for offshore activities, and sets out provisions to regulate such activities.

THE MEANING OF "OFFSHORE COMPANY"[2]

MIBAA essentially provides for 2 categories of offshore company. The first category is open to any company which meets a number of general requirements. The second category consists of certain types of companies involved in banking and insurance. Companies in both categories may also have to fulfil certain specific conditions depending on the nature of the activities in which they are engaged.

The general conditions to which the first category of company is subject basically require that an offshore company must be a private company registered under Maltese law, whose objects are limited to activities carried on from Malta in a foreign currency by and with persons who are not resident in Malta. Such an offshore company's possession of property in Malta is in effect restricted to that required for its operations from Malta. Most importantly, none of the capital or voting rights in the company may be controlled directly or indirectly by a Maltese resident and either the company's sole director or its secretary must be a "nominee company"[3]. (The nominee company requirement may be waived in the case of companies of international standing which are captive insurance companies or which specialize in the management of such companies). Finally, all offshore companies (in both categories) must be registered as such with the Malta International Business Authority to which registration and annual fees are payable.

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1. See *Gasque vs. IRC*, 23 *Tax Cases* ("T.C.") 210 and *Egyptian Delta Land and Investment Co. Ltd. vs. Todd*, 14 T.C. 138.
2. See MIBAA Secs. 22 and 23.
3. The subject of "nominee companies" is dealt with at length in Part III of MIBAA at Secs. 42-51. Broadly, a nominee company is a private company formed solely for the purposes of acting in that capacity for offshore companies. At least 60% of the shareholders must be Maltese residents and there must be at least 3 directors, at least 2 of whom are Maltese citizens of a certain standing (for example advocates or certified public accountants).

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The second category comprises 3 kinds of company. The first is an overseas banking or insurance company of international standing with a branch in Malta which carries on offshore activities. Such a company is referred to as an "offshore overseas company" and is subject to the restriction on the possession of property in Malta. The second kind of company in this category is a subsidiary of an internationally recognized banking or insurance company formed under Maltese law exclusively for the purpose of carrying on offshore banking or insurance activities. Such a company is designated an "offshore subsidiary company" and must have a name which includes the name of its holding company and clearly shows that it is a subsidiary of that company. No part of the capital or voting rights in an offshore subsidiary company may be held by a Maltese resident and the restriction on the possession of property in Malta applies. The third kind of company in the second category is known as an "offshore local company". An offshore local company is a subsidiary established under Maltese law for the purpose of carrying on exclusively offshore banking or insurance business. The parent must itself have been formed and registered under Maltese law and be licensed to carry on the business of banking or insurance under the appropriate Maltese act. In addition to the holding of the parent one other person resident in Malta may hold up to 1% of the share capital (or 1000 liri in nominal value if this is less). Offshore local companies are subject to an additional requirement in that permission must be obtained from the Minister responsible for finance to operate as offshore banking or finance companies. There is no restriction on their ownership of land in Malta.

MIBAA allows for offshore companies to be either non-trading or trading companies with those falling into the latter classification being further divided into banking, insurance and general trading companies. These classifications are significant in a number of contexts throughout MIBAA, one of them being taxation which will now be discussed.

TAXATION TREATMENT OF OFFSHORE COMPANIES

The main provisions of MIBAA relating to the tax treatment of offshore companies are contained in Sec. 30. Trading offshore companies remain subject to the Income Tax Act 1948, as amended, but pay tax on chargeable income at a reduced rate of 5% and are released from liability to withholding tax on interest paid by them to non-residents. No tax is chargeable on dividends distributed by trading offshore companies. Any reduction of company tax by way of double taxation relief is, however, lost as are the set-offs and credits otherwise available to those in receipt of dividends and other payments from such companies. (For example, a Maltese parent company in receipt of dividends from its subsidiary, a local offshore company, loses its right to a credit for company tax paid on the profits out of which the dividends are distributed.)

Non-trading offshore companies are relieved of all liabilities under the Income Tax Act.

Other advantages extended to all offshore companies are that their shareholders, debenture holders, etc. are freed from the obligation to make any returns which could otherwise be required under the Income Tax Act, and that any proceedings before the Special Commissioners or the Court of Appeal are conducted in camera.

Apart from income tax, there are also exemptions from death and donation duties, stamp duties, exchange controls, customs duties and social security contributions.

CONTINUANCE OF COMPANIES

MIBAA alters the principle of once and for all domicile for companies so as to bring Malta in line with other offshore financial centres. Sec. 39 provides for the "continuance" of both Maltese registered offshore companies and corporations registered in other countries which, if registered under Maltese law, would qualify as offshore companies under MIBAA.

In effect, MIBAA enables a Maltese offshore company to transfer to another jurisdiction and a foreign offshore company to convert to a Maltese offshore company without liquidating or reorganizing in the other country. In this process, the company continues to exist and hence can retain ownership of all its assets. Clearly, this facility is extremely valuable where assets situated in a third country need to be protected. Rapid and easy movement from one country to another is advantageous in a wide variety of circumstances; for example, where a company wishes to acquire another cover of confidentiality, or to acquire the status granted by a particular jurisdiction more adapted to the nature of the offshore company concerned, because of the easier accessibility of the new home territory or more familiarity with its laws.

CONDITIONS FOR CONTINUANCE

Under the provision of MIBAA continuance of either inward bound or outward bound companies is subject to 2 basic conditions: the statutes of the foreign corporation or the Maltese offshore company must grant the power to continue, and continuance must be approved by an extraordinary resolution of a Maltese offshore company desiring to emigrate, or by an equivalent action in the case of a foreign corporation.

As a general rule, all offshore companies have the power to continue written into their statutes. Where a company is registered in a jurisdiction which allows continuance, it should be a matter of principle to include this provision in the statutes. Under Maltese law, a company's statute can easily be changed but the process may not be so simple in other jurisdictions and time may be of the essence in situations where the question of continuance arises.

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Under Maltese company law an extraordinary resolution[4] requires approval by not less than 51% of the voting power in the company. The actual votes cast are of relative importance as it is the *total* voting power of the company which forms the basis for approval or rejection of a motion.[5]

In the case of a foreign corporation desiring to continue as an offshore company under MIBAA, the decision must be taken in a manner equivalent to an extraordinary resolution under the company law of Malta. Obviously, it is impossible to provide criteria of universal application; every case must be examined on its own merits. However, despite the pitfalls in comparing laws of different jurisdictions, the principle should not be difficult to apply in practice.

RIGHTS OF DISSENTING MEMBERS

Members of the company who do not agree that continuance under MIBAA or a foreign jurisdiction should be effected must also be taken into account. Resolution of such conflicts depends upon local legislation and/or the statutes of the company itself.

Sec. 39(3) of MIBAA refers to situations where continuance "entitles or requires the body corporate or offshore company, as the case may be, to redeem the interest of dissenting persons whose decision is required". The entitlement or requirement may exist either as a provision of the law under which the company desires to continue or under which it at present is constituted, or as a requirement in its statute.

The MIBAA itself does not specifically mention any such requirement or entitlement so that in the case of a Maltese offshore company wishing to continue under a foreign jurisdiction, the issue only arises if the company's statutes have a provision to this effect. Other jurisdictions, however, may have different legislative provisions and this factor should be kept in mind.

Redemption can take place either by agreement or as the Maltese court may on the request of either party establish. Jurisdictional conflicts may arise in the sense that equivalent provisions governing foreign corporate bodies desiring to continue in Malta and Maltese offshore companies desiring to continue abroad may be found in other laws. The MIBAA contains no provision to resolve this type of conflict.

FOREIGN LAW AND CORPORATE ENTITIES CONTINUING IN MALTA

A foreign corporate entity wishing to continue in Malta can do so regardless of the provisions of law under which it was established. This may create various problems if, after continuation in Malta, assets or persons (including officers, agents or shareholders) remain liable under foreign law. Assets can usually be fairly easily removed from the other jurisdiction but officers, agents or shareholders may need to assess their position carefully.

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MIBAA states that, if a foreign entity is continued as an offshore company under its provisions, it ceases to be a body corporate under the foreign jurisdiction; that it continues its corporate existence and retains all its assets, rights and liabilities as a company; and that the continuance "shall have effect notwithstanding anything contained in the law of its former jurisdiction". These provisions, however, are unilateral and they appear to dispense too readily with what the legislation of the former jurisdiction may require.

MIBAA AND COMPANIES CONTINUING ABROAD

MIBAA contains various requirements for a Maltese offshore company desiring to continue abroad:

(a) dissenting members may demand redemption of their shares and they have the right of recourse to Maltese courts in case of disputes;
(b) continuance, or an equivalent procedure, must be allowed under the foreign jurisdiction;
(c) there must be a continuance of the corporate existence under the new jurisdiction and the corporate entity so established must succeed to all the assets, rights and liabilities of the offshore company;
(d) the offshore company will not cease to be a company subject to Maltese jurisdiction until the Registrar of Partnerships in Malta has received written notice of the continuance and until he has registered such continuance and has struck the name of the company from the Register.

Most jurisdictions which contemplate late continuance have similar provisions.[6] Although the MIBAA tends to ignore their existence in the case of companies desiring to continue under their own jurisdiction, the possible repercussions clearly must be borne in mind when continuance under Maltese law is contemplated.

PROCEDURE FOR CONTINUANCE UNDER MIBAA

The procedure for continuance as an offshore company under the MIBAA is fairly straightforward. It requires that:

(a) there must be an instrument of continuance; this will generally be a copy of the extraordinary resolution (or the equivalent thereof) in which the company resolves to continue under MIBAA;

4. What constitutes an extraordinary resolution is normally established by the company's statutes. However, certain basic issues such as amendments to the statutes or voluntary liquidation are by law necessarily subject to extraordinary resolution. Under the MIBAA, continuance is also subject to an extraordinary resolution.
5. In many cases the necessary majority for approval of an extraordinary resolution is fixed higher than 51%. In some cases it is as high as 100% for certain extraordinary motions; exceptionally, 100% may be required for all such motions.
6. See, for example, Secs. 84-88 of the International Business Company Ordinance, 1984, British Virgin Islands.

(b) the instrument must also contain the equivalent of a Memorandum and Articles of Association required under Maltese law for the registration of a private company;[7]
(c) the company must have the structure and objects of the type[8] of Maltese offshore company into which it is desired to convert;
(d) the instrument approving continuance must be delivered to the Registrar of Partnerships who will accept it as being equivalent to the delivery of a Memorandum and Articles of Association as is normally done upon registration of a company under Maltese law.

MIBAA speaks in terms of a document which is the "equivalent of a memorandum and articles of a private company as is required by this Act". The provision begs the question as it does not set forth what is considered to be such a document. Unless the foreign corporate entity was established under a company law similar to Malta's, it may be advisable for the resolution approving continuance also to adopt a statute which satisfies the requirements of Maltese law. This can usually be accomplished without any loss of time; any amendments to bring the statute precisely into line with the owner's requirements can be effected later and, as indicated above, the relative procedures under Maltese law are fairly simple.

A private company is one which does not offer its shares for subscription to the public and which has no more than 50 shareholders. It cannot issue bearer shares (though this restriction may be circumvented in the case of offshore companies through the use of nominee companies under MIBAA).

As discussed above, MIBAA contemplates 4 types of offshore companies: banking, insurance, general trading and non-trading. It is highly unlikely that any banking or insurance companies will avail themselves of the continuance provision. Nor will many general trading companies be involved in such a move although companies trading in restricted areas may be interested in the device. Continuance, however, is primarily intended for the non-trading company, i.e. the holding company whose main function is that of holding and protecting assets. It should be noted that the non-trading company can only be registered with the Registrar of Partnerships through the agency of a nominee company established pursuant to the provisions of MIBAA.

CONCLUSION

This article has considered only the continuance provisions of MIBAA. Though it has not attempted to review MIBAA as a whole continuance must be seen in the wider context of the Act. Of particular importance here are the provisions concerning the nature and functions of nominee companies which play a vital role in most matters relating to offshore activities in Malta. The ultimate accountability of nominee companies and the severe penalties to which they are exposed in the event of any misconduct is likely to deter them from introducing offshore companies with doubtful credentials. This feature of MIBAA in turn links the Act itself to a wider context for it reveals the kind of offshore centre which it is envisaged that Malta will become.

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7. A Memorandum of Articles of Association under Maltese law contains 5 essential elements: name of the company, registered address, objects, capital structure, and names of directors. The Articles of Association constitute the internal law of the company. They can be incorporated in the Memorandum of Association or attached in a schedule thereto or stated with reference to the First Schedule to the Commercial Partnerships Ordinance (amended as required).
8. This refers to the 4 different types of offshore company mentioned in Sec. 23.

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NIGERIA:

1989 Budgetary Changes to Tax Laws

A.C. Ezejelue

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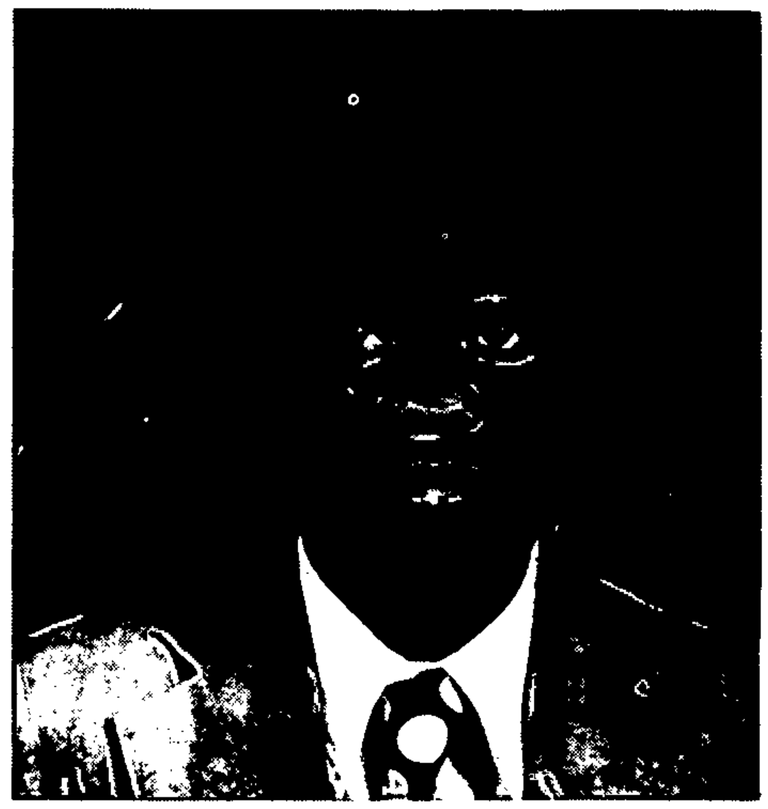

I. INTRODUCTION

During the era immediately preceding the introduction of the Structural Adjustment Programme (SAP)[1], Nigeria's economy was almost totally depressed. By the end of 1987, however, mild salutary effects were discernible.[2] In spite of the formidable difficulties for the masses that followed the policy to restructure the economic system, by the end of 1987 SAP had not only shown signs of arresting further deterioration of the economy but also produced a modest growth in domestic output.[3]

In 1988 the Federal Government adopted policy measures to support and preserve the achievements made under SAP. In addition, it reflated the economy and introduced expansionary monetary and fiscal policies, all aimed at stimulating and promoting aggregate domestic output and mitigating the level of unemployment. These measures improved real output in almost all major sectors of the economy, in particular the industrial, agricultural and petroleum sectors.[4] For instance, at ₦ 82.46 billion the Gross Domestic Product (GDP) at 1984 constant factor cost increased by 4.1% in 1988, compared with 1.8% in 1987.[5] However, these improvements in domestic production were achieved at the cost of a higher rate of inflation[6], intense pressure on external factors (particularly on the exchange rates) and persistent unemployment[7] – especially among school leavers and university graduates.

In the 1989 Federal Budget, the Government proposes to continue the process of consolidating the gains made by SAP. Briefly, the Government intends to curtail inflation, check wasteful expenditure, encourage industrial and agricultural production, create more job opportunities and stimulate non-oil exports, thereby promoting growth in the economy and the general welfare of the Nigerian people. In order to achieve the proposals for 1989, a mixture of fiscal, monetary and credit policy measures has been introduced. The fiscal measures include some review of tax policy and amendments to existing tax laws. This article highlights and examines the changes in the tax laws introduced in the 1989 Federal Budget.

II. TAX POLICY AND AMENDMENTS TO TAX LAWS

Since 1986, a number of tax policy reviews and tax incentives have been introduced. Some of the policies and incentives which will be retained in 1989 include lower personal and corporate tax rates and incentives, the withholding tax on investment income, small business relief, additional capital allowances, tax exemptions for dividends and tax relief on mortgages for owner-occupier dwellings.[8] New policies and incentives have been introduced in 1989 in the areas of sales tax, withholding tax, gratuities paid in the private sector, personal allowances for the disabled, reserve for research and development (R & D), mergers and takeovers, excess profits tax and the penalty for late returns. Moreover, Nigeria has introduced a new industrial policy and a package of tax incentives.

1. SAP was introduced in 1986 by the Babangida military government.
2. These effects, however, were shrouded by the mounting difficulties also created by SAP, i.e. a higher rate of inflation, scarcity of funds, closure of industries, unemployment, reduced real income for workers, low aggregate demand and pressure on the exchange rate.
3. However, although the rate of growth in domestic output was much less than anticipated, the suffering of the people was beyond that envisaged. For instance, there were unresolved problems of large scale unemployment, reduced real income (particularly of workers), low aggregate demand and non-liquidity.
4. According to the 1989 Budget Breakdown by the Minister of State for Planning and Budget, Alhaji Abubakar Alhaji, the following increases were recorded in 1988 as against 1987: (i) in crude petroleum production there was an estimated increase in 1988 by 9.4% in contrast to a decline of 10.4% in 1987; (ii) in agricultural production the estimated increase was 3.5% compared with only 2.5% in 1987; (ii) in manufacturing production the estimated increase was 3.5% compared with only 2.5% in 1987; (iii) in manufacturing production the increase was about 8% as against a lower growth of 4.2% in 1987; (iv) in staple food production there was an estimated increase of 12.1% as against 5.2% in 1987. (Lagos: *Business Times*, 9 January 1989 at 8-9.)
5. See note 4.
6. Available data showed that the inflation rate in 1988 was about 25% compared with 10.2% in 1987.
7. For example, aggregate employment in the manufacturing sector declined by 2.8% in 1988.
8. For a detailed discussion of these tax policies and incentives, see A.C. Ezejelue, "Nigeria: Recent Amendments to Tax Laws", 42 *Bulletin for International Fiscal Documentation*, 7 (1988) at 315.

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A. Sales tax

A uniform sales tax was introduced with effect from 30 June 1986.[9] It covers a variety of goods and services which can be varied or amended under the enabling Decree. Under the 1989 tax policy, the sales tax rates on beer and soft drinks which hitherto have been fixed at 3 kobo and 1 kobo per bottle, respectively, have been replaced by a single rate of 5% of the manufacturers' selling price to distributors. With this change, a uniform sales tax rate is in effect for all commodities covered by the Sales Tax Decree.

B. Withholding taxes

Three tax policy areas have been introduced for various withholding taxes, i.e. withholding tax on bank deposits, rental income and directors' fees.

1. Withholding tax on interest on bank deposits

The introduction of a withholding tax on bank deposit interest is new. With effect from the 1989 fiscal year, all banks, without exception, are required to make tax deductions at source at the rate of 15% on interest paid or credited by the bank to accounts of all customers. For passbook savings accounts, the deductions at source will be made only if the amount of the deposit is ₦ 50,000 or more. All banks are required to promptly account for the deductions to the appropriate tax authorities.

This policy may discourage customers from accumulating large deposits by way of savings in banks. Where the need to deposit large sums of money in the bank is inevitable, it may lead to having multiple deposits or savings accounts in the same or different banks, none of which amounts to ₦ 50,000. On the other hand, the policy may encourage investments by discouraging tying down large sums of money in idle deposits.

2. Withholding tax on investment income

A withholding tax of 15% of the gross amount of dividends, interest, royalties and rents paid or credited to any person by a recognized payer, or whenever such payment becomes due from one company to another or to any person to whom the provisions of the Income Tax Act 1972 (Armed Forces and Other Persons) (Special Provisions) apply, has been in place since 1985.[10] However, with effect from the 1989 fiscal year, the withholding tax of 15% on certain rental income has been exempted; included in the exemption are fees paid or payments for the use or hire of any equipment, charter vessels, ship or aircraft. These also include payment for the use or hire of movable and immovable property.

3. Withholding tax on directors' fees

With effect from 1 January 1988 withholding tax on directors' fees has been fixed at 15% and this policy extends to 1989.

C. Gratuities paid in the private sector

Since 1 January 1986, gratuities[11] paid to employees in the private sector have been exempt from tax. By virtue of this exemption, a gratuity paid to any employee in the private sector is exempt from tax, subject to a tax-free maximum amount of ₦ 50,000. However, with effect from 1989, the tax-free amount in respect of gratuities has been increased to ₦ 100,000. Any amount in excess of the maximum tax-free amount of ₦ 10,000 paid as gratuity is to be taxed at the appropriate rate.

D. Personal allowances for the disabled

In order to encourage the disabled, it has been provided that, with effect from the 1989 fiscal year, a disabled person who uses special equipment and the services of an attendant in the course of a paid employment shall be entitled to an additional personal allowance of ₦ 2,000 or 10% of his earned income, whichever is less. With effect from January 1987, a lower personal income tax of ₦ 1,000, plus 12% of earned income, has been in force for all earned income of individuals. It is to this prevailing personal allowance that the additional relief for the disabled has been added.

The 1989 Budget breakdown appears to emphasize that the additional allowance for the disabled relates only to paid employment. However, many disabled persons earn income from self-employment in a business, profession or vocation. It would be inequitable not to include the earned income of the self-employed disabled persons in the new dispensation.

E. Reserve for research and development

Since 1987 the Government has granted a number of fiscal measures to encourage the R & D efforts of companies and individuals. For example, with effect from 1987, a relief equal to the total amount of the equity shareholding held by a taxpayer or 25% of his total income in a year of assessment, whichever is less, is claimable by any individual taxpayer who holds equity shares in any company incorporated in Nigeria solely for the purpose of R & D. In addition, a new classification of capital expenditure (known as Qualifying Research and Development Expenditure)[12] was

9. See J.M. Elegido, "Nigeria: The Sales Tax Decree 1986", 40 *Bulletin for International Fiscal Documentation*, 7 (1986) at 300. See also Mahesh C. Purohit, "Reforming Sales Tax in Developing Countries: A Study of the Nigerian Sales Tax System", 40 *Bulletin for International Fiscal Documentation*, 1 (1986) at 5.
10. Finance (Miscellaneous Taxation Provisions) Decree 4, 1985. See also Ezejelue, note 8.
11. For this purpose, gratuity means the amount paid or credited to an employee for past services in Nigeria for a period of not less than 10 years.
12. R & D expenditure includes expenditures incurred on equipment and facilities, patents, licences, secret formulae or processes or for information concerning industrial, commercial or scientific processes, technical feasibility of products or processes and the purchase, searching for, discovering and testing products or processes for future markets or uses, and other similar costs.

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introduced with effect from 1987.[13] In view of the fact that R & D effort is usually expensive and time-consuming and the result is of a permanent nature, such expenditure is capitalized; the present rate of capital allowance is 25% and 12½% for initial and annual allowances, respectively.

With effect from the 1989 fiscal year, a tax incentive has been introduced in respect of reserves made by companies for R & D. Henceforth, where a company sets aside, out of its annual profits, any amount for R & D, the amount so set aside as reserve will be allowed as a deduction from the profits of the year before any tax. The amount of the deduction, however, shall not exceed 10% of the total profit of the company for that year.

F. Mergers and takeovers

With effect from 1989, any proposals for mergers and takeovers of companies shall be sent not only to the Security and Exchange Commission (SEC), the Nigerian Enterprises Promotion Board (NEPB) and the Nigerian Stock Exchange (NSE), but also to the Federal Board of Inland Revenue (FBIR). The purpose of sending the proposal to the FBIR is to enable the Board to assess the tax implications of the proposal; until this assessment is made, the restructuring proposal cannot be consummated.

G. Excess profits tax

Prior to the 1989 Budget, only banks were subject to excess profits tax at the rate of 10%. Henceforth, excess profits tax has been extended to all companies, and the rate has now been increased to 15% for both banks and companies. Industrialists appear to frown at the excess profits tax, and it is feared that the tax will discourage investment. The present excess profits tax is analogous to a one-time super tax[14], a child of circumstance, imposed as a war time measure, on profits earned by companies in Nigeria in excess of ₦ 10,000 or 15% of share capital, whichever was higher. It was, however, scrapped with effect from the 1972-73 fiscal year.

H. Penalty for late returns

In addition to the statutory annual returns required to be filed by companies with the Registrar of Companies, Sec. 40 of the Companies Income Tax Act 1979 (CITA) (as amended) requires that every company shall, at least once every year of assessment, make and deliver to the FBIR the following:

(i) audited accounts and a true and correct statement in writing containing the amount of profits from every source;
(ii) such return as may be required with respect to any profits, allowances, reliefs, deductions, etc. These returns must be submitted to the Board no later than 6 months after the close of the company's accounting year, or in the case of a newly incorporated company, within 18 months from the date of incorporation or not later than 6 months after the end of its first accounting period, whichever is earlier.

In addition to the above standard statutory returns, the Board has the power under Secs. 41 and 42 of CITA to require further returns or additional information as well as supporting returns, books and documents.

In 1989, the penalty for filing late returns of income tax or failure to submit accounts on due dates will remain at ₦ 5,000. This penalty will be imposed by the FBIR without recourse to courts of law.

III. TAX INCENTIVES PACKAGE OF THE NEW INDUSTRIAL POLICY

The 1989 Budget recognizes agriculture and manufacturing industries as the twin pillars on which support for the recovery programme should be based. Consequently, the Budget promises that "the manufacturing sector, just like agriculture, will receive priority policy attention in 1989". Among the most important areas that will receive attention are small scale industries, tariff protection and encouragement of the flow of foreign investment to manufacturing industries. According to the Budget, attention will be focused "on the development of small scale industries in view of their importance as engine of growth, and the fact that they are most conducive to the creation of more jobs per unit of naira investment, and they are also easily located in the rural areas". Hence, the new Nigerian industrial policy with its package of incentives is the fulfilment of the 1989 budgetary provisions.

The first attempt to formulate an industrial policy for Nigeria was undertaken in 1980 by the Shagari civilian administration. This attempt gave birth to the publication entitled "Nigeria's Industrial Policies: Guidelines to Investors". Although the attempt was welcome, the policies were not far-reaching. A more comprehensive and extensive industrial policy was launched by President Ibrahim Babangida in Abuja on 14 January 1989. The launching of this policy, at a time when industrialization holds the key to our economic recovery and development, is well timed.

The goal of the new industrial policy is to achieve an accelerated pace of industrial development by creating a new investment climate and mobilizing the private sector to take the lead in entrepreneurship while the Government provides infrastructure and security. The policy focuses primarily on small and medium-scale industries.[15] The new policy satisfies the spirit and philosophy of the SAP, particularly in the areas of

13. Finance (Miscellaneous Taxation Provisions) Decree 1987.
14. See A.C. Ezejelue, "Nigeria: Tax Considerations for Investment and Business Decisions", 33 *Bulletin for International Fiscal Documentation,* 8/9 (1979) at 398.
15. Small-scale industries are defined as those with total investment of between ₦ 100,000 and ₦ 2 million including working capital, but excluding land.

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disengagement of Government from productive economic activities and the promotion of market forces. The principal elements of the new policy include:
(a) providing employment opportunities,
(b) increased export of manufactured goods,
(c) dispersal of industries,
(d) improving the technological skills and capability available in the country,
(e) increased local contents of industrial output,
(f) attracting foreign capital, and
(g) increased private sector participation in the manufacturing sector.

In order to meet the central objective of accelerated industrial development, the following strategies and policy measures have been taken by the Government:
(a) to encourage increased private sector participation in the industrial sector, and privatizing and commercializing holdings in certain existing industrial enterprises;
(b) to play a catalytic role in establishing new core industries;
(c) to provide and improve infrastructural facilities;
(d) to improve the regulatory environment;
(e) to improve the investment climate;
(f) to establish a clear set of industrial priorities; and
(g) to harmonize industrial policies at federal, state and local Government levels.

To this end, a package of 5 groups of incentives has been designed to promote investment, employment, product mix and various other aspects of industry:
(a) fiscal measures on taxation and interest rates;
(b) effective protection of import tariffs;
(c) export promotion of Nigerian products;
(d) foreign currency facility for international trade; and
(e) development banking.

The fiscal measures on taxation aim to provide for certain deductions and allowances in the determination of taxes payable by manufacturing enterprises. These incentives to industry are in the following areas.[16]

A. Pioneer status

Under the provisions of the Income Tax Relief Act 1958, as amended by the Industrial Development (Income Tax Relief) (Decree 22 of 1971), certain public companies are accorded pioneer status and are thus granted specific tax holidays on their corporate income. The purpose of granting pioneer status under this law is to encourage and stimulate the establishment of industries that the Government considers beneficial to Nigeria. During the period of tax holiday, the companies are expected to achieve a high level of profitability. To qualify, the relevant company is declared a pioneer industry or its product a pioneer product. The law applies to both public and private limited liability companies.

The tax exemption covers a non-renewable period of 5 years for pioneer industries and 7 years for industries located in economically disadvantaged areas. Additional tax concessions are available to industrialists who take initiative in the following areas:
(a) local raw materials development,
(b) local value added,
(c) labour intensive processes,
(d) export-oriented activities,
(e) in-plant training, and
(f) investment in economically disadvantaged areas.

Relief for losses incurred during the tax holiday period are deductible from profits made after expiration of the period. Additionally, capital allowances due during the holiday period are deferred until the period expires.[17] The Industrial Development Coordination Committee (IDCC) is responsible for administration of these and other incentives.

B. Tax relief for R & D

As noted above, the Government has for some time been encouraging companies and individuals in the area of R & D via a number of fiscal measures. A further incentive to industrial establishments to engage in R & D for the improvement of their processes and products has been provided in the new Nigerian industrial policy. Under the new policy, up to 120% of expenses on R & D shall be tax-deductible, provided that the R & D activities are carried out in Nigeria and are connected with the business from which income or profit is derived. In the case of R & D on local raw materials, however, 140% of the expenses incurred are allowable. Where the research is long-term it will be capitalized and written off against profits of a number of years.[18]

C. Companies Income Tax Act 1979

In order to encourage potential and existing investors and entrepreneurs, the following reliefs shall apply under the new policy:
(1) the corporate tax rate of 40% which took effect from 1987 is to remain in force;
(2) the following rates of capital allowances shall apply:

Qualifying Expenditure in respect of	Initial allowance	Annual allowance
	(%)	(%)
– Building expenditure	5	10
– Industrial building expenditure	15	10
– Mining expenditure	20	10
– Plant expenditure (excluding furniture and fittings)	20	10
– Furniture and fittings expenditure	15	10

16. *Business Concord* (Lagos: Nigeria) of 31 January 1989 at 9 and 3 February 1989 at 13. What follows is based on the articles in these 2 issues of the *Business Concord*.
17. Ezejelue, note 14.
18. For the purposes of granting the tax relief under the new Nigerian industrial policy, the genuineness of the R & D activities shall be determined by the Federal Ministry of Finance in consultation with the Federal Ministry of Science and Technology. The results of the research can be patented and protected in accordance with internationally accepted industrial property rights.

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– Motor vehicle expenditure	25	20
– Plantation equipment expenditure	20	33⅓
– Housing estate expenditure	20	10
– Ranching and plantation expenditure	25	15
– Research and development expenditure	25	12

Apart from the split of the former plant expenditure into 2 separate plant as well as furniture and fittings expenditures, and the creation of the new classification of capital expenditure, known as research and development expenditure, all of which took effect from 1 January 1987, all the other qualifying capital expenditures and their rates of initial and annual allowances have been the same since 1985.[19]

The restriction of the total amount of capital allowances that may be claimed in Nigeria in any year of assessment under the Finance (Miscellaneous Taxation Provisions) Decree No. 4 of 1985, to a maximum of 75% of the profits in the case of manufacturing companies and 66⅔% in other cases is still in force under the new industrial policy. Also in force under the policy is the exemption of companies in agro-allied industry from the restriction imposed on the total amount of capital allowances.[20]

In addition to the above reliefs introduced by the new industrial policy in respect of the Companies Income Tax Act, the following regulations shall also apply:

(a) Failure to pay corporate tax on the due date shall attract a penalty of 10% per annum on the outstanding amount.
(b) Companies are required to submit detailed tax computations along with their returns and audited accounts as well as the Industrial Inspectorate Department acceptance certificate.[21]
(c) A taxpayer who wishes to appeal a court decision with respect to tax payable must first pay the disputed tax. The body of Appeal Commissioners and the courts have been empowered to impose a penalty of 10% where an appeal proves to be frivolous or groundless.
(d) The tax authority's power to obtain information on banks' customers for tax purposes shall apply to both individuals and companies under the new industrial policy.[22]

D. Tax-free dividends

Also embodied in the new policy is the provision on tax-free dividends which took effect from 1987.[23] An individual or a company deriving dividends from any company shall enjoy tax-free dividends for a period of 3 years if:

(a) the company paying the dividends is incorporated in Nigeria;
(b) the equity participation is imported into Nigeria between 1 January 1987 and 31 December 1992; and
(c) the recipient's equity in the company constitutes, at least, 10% of the share capital of the company.

If the company paying the dividends is engaged in agricultural production within Nigeria, or in processing of Nigerian agricultural products produced within Nigeria, or in the production of petro-chemical or liquefied natural gas, the tax-free period shall be 5 years.

E. Tax relief for investment in economically disadvantaged local government areas[24]

Entrepreneurs who invest in economically disadvantaged local government areas are entitled to the following special income tax and other concessions, among others:

(1) 7 years income tax concessions under the pioneer status scheme;
(2) special concessions by relevant state governments; and
(3) an additional 5% over and above the initial capital depreciation allowance under the Companies Income Tax Act (Accelerated Capital Depreciation).

F. Elimination of double taxation on investment income

The amendment to the Finance (miscellaneous Taxation Provisions) Decree 4 of 1985 which was to eliminate double taxation on investment income is part of the incentives to industry under the new industrial policy. This amendment which took effect from 1988 year of assessment is to specifically exempt investment income (i.e. dividends, interest, royalties and rents) from further taxation once the 15% withholding tax is deducted, i.e. the income will no longer be taxed over and above the 15% withholding tax.[25]

Since the amendment on franked investment income came into effect on 1 January 1985, companies can pay interim company dividends without any double taxation. This is also a feature of the new industrial policy.

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19. Finance (Miscellaneous Taxation Provisions) Decree 4, 1985, Sec. 36. See also: A.C. Ezejelue, "Nigeria: Crucial Amendments to Income Tax Laws", 39 *Bulletin for International Fiscal Documentation,* 12 (1985) at 533; Ezejelue, note 8.
20. If the leased assets are used in an agro-allied company, the full 100% capital allowances claimed will be granted. Moreover, where the leased assets are agricultural plants and equipment, there will be an additional investment allowance of 10% on such expenditure.
21. Sec. 49(3) of the Companies Income Tax Act 1979 (as amended).
22. Finance (Miscellaneous Taxation Provisions) Decree 4, 1985.
23. For more details, see Finance (Miscellaneous Taxation Provisions) Decree 1987.
24. For the purpose of administering these incentives under the new policy, the country is grouped into the following zones:
Zone 1 – Industrially and economically developed local government areas.
Zone 2 – Less industrially and economically developed local government areas.
Less industrially and economically developed and least industrially and economically developed local government areas are defined in terms of inadequacies of:
– industrial production in gross and per capital basis available,
– social and economic infrastructures,
– level of labour market development.
25. See note 8.

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G. Additional capital allowance

As a further incentive to industry under the new industrial policy, an additional annual capital allowance of 5% on plant and machinery for "manufacturing exports"[26] has been introduced. The proviso to the application of this additional incentive is that the product manufactured and exported has at least 40% local raw materials content or 35% value added.

H. Tax relief on loan interest in export-oriented industries

A tax relief on interest accruing from any loans granted to aid investment in export-oriented industries is to be granted as an additional incentive to industry.

IV. CONCLUSION

The structural adjustment programme package which has constituted the base of Nigeria's economic structure since mid-1986 comprises a set of economic reform objectives designed to improve the efficiency of public administration, restructure expenditure policies and bring about financial discipline. The programme is also expected to expand non-oil exports, stimulate research and increase local sourcing of industrial input, revitalize the agricultural and industrial sectors to achieve self-sufficiency in food and industrial production, eliminate the accumulation of further external debts, privatize commercial interests of Government, encourage a new inflow of foreign investment into Nigeria and adopt a realistic exchange rate policy.

The SAP package has always included the introduction, in every fiscal year of its operation and consolidation, of supportive monetary, fiscal, credit and other measures designed to stimulate local industrial capacity as well as to attract foreign investment. If all goes well with SAP and its supportive measures (usually introduced as budgetary policies), it will be able to generate employment, improve gross domestic product as well as the standard of living of the people, and will thus provide a firm basis for economic and social growth.

In effect SAP has become the fundamental economic doctrine which must be supported by every other economic policy. Hence the Government's budgetary proposals for 1989 are predicated on its continued determination to consolidate the gains of SAP. It is therefore not surprising that the fiscal measures in the 1989 Budget contain various tax policies and incentives geared towards encouraging industrial and agricultural production on local sourcing of raw materials, research and development, creation of more employment opportunities and stimulation of non-oil exports, thereby promoting growth in the economy and in the general well-being of Nigerians of all classes.

26. "Manufacturing exporters" for this purpose are those that export at least 50% of their annual turnover.

[continued from page 510]

- 23 May 1990: Talks on debt/equity funding and leveraged buy-outs;
- 12 June 1990 annual general meeting.

The programme of the Manchester Branch is:

- 18 October 1989: Treaty developments and taxation;
- 22 November 1989: Controlled Foreign Companies and Captive Insurance Companies;
- 17 January 1990: International treasury management;
- 21 February 1990: The Netherlands;
- 21 March 1990: International mergers;
- 25 April 1990: Tax cases review;
- 6 June 1990: U.S. tax update.

SWISS BRANCH

The Swiss Branch of IFA announced a special meeting to be held on 2 November 1989 in Geneva. During this meeting the Annual Congress of IFA held in September 1989 in Rio de Janeiro will be evaluated and brief introductions will be given on the subjects of this Congress. Dr.iur. Desax, M.C.L. (partner Pestalozzi, Gmür & Heiz, attorneys) will discuss the subject of disregard of a legal entity for tax purposes and Mrs. J. Gremaud (licenciée en droit, expert-comptable diplomé and director of the Société Plafida in Geneva) will deal with the administrative and compliance costs of taxation.

Thereafter the subjects of the Annual IFA Congress to be held in August 1990 in Stockholm will be discussed. Mr. Peter Riedweg (partner Price Waterhouse, Zurich will introduce the subject of international leasing whereas the subject of mutual (international) assistance by tax authorities through the exchange of information will be presented by two speakers, i.e. Dr. H. Grüninger (attorney of the Law Offices of Homburger, Achermann, Müller & Heini, Zurich) and by A.H. Keller (attorney, Schweizerische Treuhandgesellschaft, Zurich).

Finally, Mr. Pierre-Alain Loosli, Director-General of the Cantonal Tax Department of Geneva, will discuss special aspects of the new Swiss Federal Law on Tax Harmonization.

Other meetings of the Swiss Branch have been planned for 8 February 1990 in Basle and on 7 June 1989 in Zurich.

The Swiss Branch also announces that on 1 November 1989 the Association Genevoise de Droit des Affaires (Geneva Association for Business Law) will organize a seminar on tax treaty shopping. The seminar will be led by Mr. Gion Clopath (attorney, expert-fiscal diplomé); Mr. Daniel Lüthi (notary, head of the division for international tax law and double taxation matters of the Federal Tax Administration, Berne); and Mr. Marshall J. Langer (attorney, Counsel Shults & Bowen, Miami, Florida, Neuchâtel).

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 50-52 of the January 1989 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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These papers were among those presented at the XXVI Congress of the Association Internationale des Jeunes Avocats (AIJA) at its annual meeting held in Munich in September 1988.

The AIJA is a non-political organisation founded in 1962 to encourage and promote cooperation and mutual respect between young lawyers from all countries around the world. It has over 2,000 members in 45 countries.

International Tax Aspects of Charities:

General Report

Jonathan S. Schwarz

Jonathan S. Schwarz, International Tax Partner at Stephenson Harwood, Solicitors, London, England. He is an English, Canadian and South African lawyer. He received his B.A. and LL.B. degrees at the University of Witwatersrand in South Africa and his LL.M. degree at the University of California, Berkeley. He is a member of the New Editorial Board of *The Oil & Gas Law and Taxation Review* and correspondent for *World Tax Report*. He is a frequent writer and speaker on tax topics.

I. INTRODUCTION

The study by the AIJA Taxation Commission on the international tax aspects of charity represents the first complete study and presentation by the Tax Commission. The question has been asked: why the taxation of charities? Surely it should be more appropriate to consider an issue of a more commercial nature?

There are many reasons for doing so. First, the subject is one that has received little examination and analysis from an international point of view. The International Fiscal Association, for example, considered the position of charitable institutions at its Congress in 1969.[1] At a seminar in 1985, the topic was examined only in a very limited way. Minimal literature exists on the subject, and indeed as will appear from the articles, the lack of reference to charities in tax treaties indicates the lack of concern with such issues. Second, the charitable or voluntary sector constitutes considerable economic activity in the world today. The U.S. article[2] indicates, for example, that in 1985 the income tax deduction for charitable contributions reduced federal government revenues by more than US$ 12.5 billion, equivalent to 4% of gross domestic product.[3]

Third, it is I believe appropriate for the AIJA Tax Commission as an organisation of young lawyers to focus its attention upon areas of human endeavour governed by extra-economic and humanitarian motives. The object of the Association and its commitment to justice should not be limited to due process before the courts but should also extend to social and economic justice for people throughout the world.[4] Finally, concern for charitable causes has become more international. Fund raising activities frequently cross national boundaries. For example, it is understood that the Band Aid charity for famine relief in Africa raised over £ 90 million sterling in over 30 countries.

II. PURPOSE AND SCOPE

The purpose of this study is to examine the taxation of charitable giving and philanthropic organisations in the international context. Although numerous national legal or tax systems do not differentiate very precisely between philanthropic organisations and other non-profit making organisations, the focus of this study is specifically on charitable or philanthropic organisations. In the broadest sense, such organisations may be distinguished from other non- profit making organisations in the sense that their aims are specifically altruistic. The study does not cover other tax-exempt organisations which are for the mutual benefit of members. Thus for example, under German tax law charity refers to 3 activities, i.e. public benefit aims,

1. *Cahiers de Droit Fiscal International,* Vol. LIV.
2. See article in this issue by Charles Irish, "Gifts Without Borders: U.S. Tax Treatment of International Charitable Contributions", at 544.
3. See *The Economist* of 4 June 1988 at 29.
4. See Statutes of Association Internationale des Jeunes Avocats, Art. 2.

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humanitarian aims and church related aims.[5] Similarly, under English common law charity in the legal sense comprises 4 principal divisions: trusts for the relief of poverty, trusts for the advancement of education, trusts for the advancement of religion and trusts for other purposes beneficial to the community.[6]

It might be noted that in some of the countries, national reporters were of the view that charities played a less significant role on the theory that the provision of a significant level of social benefits is the obligation of government.

III. NATIONAL SYSTEMS

The national reporters spent some time reviewing the tax regimes in the individual countries. It is not intended here to review the rules in detail since they are extensively described in each article. In general, however, it may be noted that most countries surveyed provide some form of tax relief usually in the form of a deduction against income tax payable. The tax relief is not unlimited and in most cases a ceiling is placed either as a percentage of income earned or a percentage of the donation, a cash limit or combination of these criteria.

Similarly, relief generally exists for charitable donations in respect of death and gift taxes. Again the precise rules differ widely from jurisdiction to jurisdiction.

In relation to the charities themselves, again a discerntable pattern indicates that the receipt of gifts is non-taxable and that generally charities are exempt from most taxes in relation to their investment income. Indeed in relation to even commercial activities that are substantially or directly related to the tax-exempt purpose, no income taxes may apply. In some cases, difficulty arises in distinguishing between such activities that are part of a commercial nature and those that are closely related to tax-exempt purposes.

IV. INTERNATIONAL DONATIONS

The rules relating to donations on an international level reveal a remarkable parochial attitude on the part of legislators. In not one of the reporting countries does domestic law permit either the same or any tax relief to donors where the donation is made to a foreign charity. Indeed it would appear that in most countries reference to charities for tax purposes is a reference to charities established under local law. Thus, a donor making a gift to a foreign charity would only be able to make such a donation out of entirely after-tax income. In the United Kingdom, this extends even to charitable activities of a foreign charity carried out within the United Kingdom.

It should, however, be noted that in numerous countries such as the United States, the Federal Republic of Germany and others, charities whose activities and objects are entirely outside the jurisdiction will nonetheless continue to be treated as a charity with the result that both its revenue raising activities will be subject to the usual tax treatment and persons making donations to it will receive applicable tax relief. This is not always the case. In Austria, for example, charities may only have domestic objects.

Interestingly in England, with respect to the category of charity which is generally beneficial to the community, this has been construed to mean of benefit to the community in the United Kingdom. Thus, while a charity may obtain tax benefits if it is established for tax relief of poverty overseas, it may not if established "for the benefit of the community" overseas, under U.K. rules.

With respect to other revenue raising activities of charity, again in the international context, the position is not promising. Since foreign charities are not generally recognised as such in most countries, investment in foreign countries is likely to be categorised according to the nature of the entity concerned. Where the charity is organised as a corporation, it will be taxed as such, and where it is organised as a trust or an incorporated association its tax treatment will follow the rules relating to taxable persons. Flowing from that, it is also noteworthy that commercial activities of charities that would be exempt from tax on the basis that they are substantially or closely related to their tax-exempt purpose in their country of origin would not normally be accorded that treatment in a foreign country, and therefore such activities would be taxable. The results are that cross-border investment by charities is inhibited and international fund raising activities become extremely complex and costly.

V. TREATIES

The position of charities under tax treaties generally is not particularly helpful in relation to the international aspects of the activities of such charities. The first major difficulty that charities have to overcome is falling within most income tax treaties at all. Art. 1 of both the OECD Model Double Taxation Convention on Income and Capital as well as the United Nations Model Double Taxation Convention between Developed and Developing Countries states that the convention "shall apply to persons who are residents of one or both of the contracting states". Thus, in order to fall within a treaty it is necessary to be a "resident" of a contracting state.

Art. 4 of both Model Conventions defines a resident of a contracting state to mean "any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or other criterion of a similar nature".

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5. See article in this issue by Wolfgang Hering, "International Tax Aspects of Philanthropic and Other Non-Profit Organisations: German Report", at 558.
6. See article in this issue by Brown, "International Tax Aspects of Charitable Giving and Philantropic Organizations: English Law and Practice", at 549.

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This form of wording is very widely used in most countries' treaties. Thus, if a foreign charity is exempt from tax or is not subject to tax in the first place, it may not fall within the definition of a residence and therefore be unable to claim the benefit of the particular treaty. The result is that charities would in such circumstances be in a less favourable position than taxable entities in relation to claiming reduced rates of tax on investment income such as dividends and interest under such treaties.

It is, however, arguable in those countries where the person in question would in ordinary circumstances be subject to taxation but is granted an exemption (for example upon application) to be able to fall within the treaty on the basis that the entity would on general principles be liable to taxation on the basis of residence, etc. The position may, however, be different in the case of charities which simply do not fall within the ambit of the relevant taxing jurisdiction.

Notwithstanding this, reference should also be made to Art. 24 of the OECD and U.N. Model Treaties. Art. 24(1) provides that nationals of a contracting state shall not be subjected in the other contracting state to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that state in the same circumstances are or may be subjected. Art. 24(2)(a) includes in the definition of "nationals" all legal persons, partnerships and associations deriving their status as such from the laws in force in a contracting state.

While the wording of the non-discrimination clause may lead one to think that perhaps charities might rely on the provisions of this article where it is adopted by contracting states, interpretation to date has not borne this out. The OECD Commentary on this clause points out that all nationals of a contracting state are entitled to invoke the benefit of this provision against the other contracting state whether they are residents or not of either contracting state. The commentary continues, however, that the provisions are not "to be construed as obliging a state which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit which are specific to that state to extend the same privileges to similar institutions whose activities are not for its benefit". This logic it explains is "justified by the very nature of these institutions' activities and by the benefit which that state and its nationals will derive from those activities".

If the OECD Commentary is read literally, then it would seem that although the clause may not apply to purely local charities, it should apply to those charities whose purposes are international in nature.

Thus, in the absence of specific provisions relating to charities they may be worse off in an international context than even profit-making enterprises which are able to benefit from tax treaties. Specific provisions relating to charities are very uncommon, however, in the huge number of treaties that exist in the world today. The United States, for example, only has provisions relating to charities in its income tax treaties with Canada, Israel[7] and the Federal Republic of Germany.

Art. XXI of the income tax treaty between the United States and Canada specifically exempts income derived by a religious, scientific, literary, educational or charitable organisation from tax in a contracting state if it is resident in the other contracting state to the extent that such income is exempt from tax in the other state. Income from a trade or business carried on by such exempt organisation is not included. The IRS commentary on the treaty states that the test of residence for this purpose is intended to be similar to the general test of residence but points out that it cannot be identical.

In the treaty between the United Kingdom and the Irish Republic, a more limited exemption from tax is provided where "the competent authorities of that other contracting state certify that such dividends are not subject to tax in that other contracting state by reason of provisions of the law of that contracting state, which afford relief from taxation to charities ... such dividends shall be exempt from any tax in the first mentioned contracting state which is chargeable on dividends". Similar provisions apply to income and gains from the alienation of immovable property.

Somewhat similar rules apply in relation to the Danish treaty in relation to dividends and in the U.K.–Federal Republic of Germany treaty in relation to interest. The Canada–U.S. treaty, along with the Federal Republic of Germany–U.S. treaty, are the only treaties that provide for comprehensive mutual recognition of charities for the purpose of determining foreign charities' income tax liability.

Treaty provisions appear to be even more scarce relating to the deductibility of donations made to foreign charities. Such provisions are to be found in the U.S.–Canada treaty and in the U.S.–Israel treaty. In the IRS Notes accompanying each treaty, it is pointed out that efforts will be made to develop procedures to simplify the determination of the eligibility of organisations in each contracting state with respect to these deductions. If the competent authorities are satisfied in each case on the procedures for determining eligibility for charitable contributions in the other state, they will accept the certification of the other competent authority so as to avoid duplication of administrative efforts or requiring recipient organisations to qualify separately in both contracting states. In the case of the U.S.–Israel treaty, the deduction cannot exceed 25% of the donor's income which is sourced in the other contracting state.

The application of this provision can be somewhat narrow as indicated in the recent Canadian decision in *Shere v. MNR*.[8] There, the appellant, a Canadian, was employed by the National Film Board of Canada and assigned to its New York office. While he was working

7. The U.S.–Israel income tax treaty is not yet in force.
8. 1989 *Canadian Tax Cases* 2286.

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in New York, his salary was paid in Canadian funds directly into a bank account in Montreal. He made donations to certain U.S. charities and claimed them as deductions in his Canadian income tax return. The decision turned on whether the taxpayer had income from sources in the United States against which he could claim the charitable deductions. The Tax Court, in upholding the claim, concluded that the territorial source of employment income was not to be determined by the residence of the employer or the fact that the employee was deemed to be resident in Canada by virtue of his employment with a government organisation. Income was held to be generated by the actual performance of the duties described in the employment contract and the place where the duties were performed, in this case New York. As a result, the donations met the requirements of the treaty and were therefore deductible in computing Canadian income tax.

It should be noted that rules differing from the OECD Model definition of residence may provide for more beneficial treatment. Thus, U.S. treaties with Australia, Jamaica, New Zealand and the United Kingdom refer to corporations or other entities organised under the law of the particular treaty country. Consequently, charities organised in corporate form as well as unincorporated entities which are treated as corporations for U.S. tax purposes may be entitled to treaty protection. The legislative histories clarify that generally tax-exempt entities are entitled to treaty benefits because of their being treated as residents of the country of organisation.

A similar lack of reference to charities is found in relation to bilateral treaties dealing with estate, inheritance and gift taxes. Both the 1966 and 1982 draft OECD Model Conventions make no specific reference to the treatment of gifts made to charitable organisations. The Commentary on the 1966 Convention dealing with non-discrimination follows a similar approach found in the Commentary on the Model Income Tax Convention, namely that the non-discrimination clause should not be construed as obliging a state which accords special taxation privileges to private non-profit making institutions, whose activities are performed for the purposes of public benefit which are specific to that state, to extend the same privileges to similar institutions in the other state.

The 1982 Commentary does, however, improve on this position by suggesting wording that contracting states would be free to adopt in the following terms: "Organisations of a contracting state shall be entitled in the other contracting state to any exemptions from or reductions of tax accorded to organisations of the same type of that other state. The type of the organisations shall be determined according to the domestic law of the state imposing tax".

References to such organisations in existing treaties are somewhat limited; specific reference is found for example in Art. 10 of the U.S.–Federal Republic of Germany estate tax treaty. In other treaties, for example, the U.K.–Netherlands treaty, Art. 10 dealing with deductions simply requires non-domiciled estates to be permitted deductions as allowed under the domestic law of the contracting states. It would appear that this would not serve to recognise charities established under the laws of the other contracting state for this purpose.

VI. MULTILATERAL ARRANGEMENTS

Few attempts have been made in this regard. The most significant is the draft European Convention on the Tax Treatment in respect of Certain Non-Profit Organisations which was considered by the Consultative Assembly of the Council of Europe in 1972. This Convention has never entered into force.

This Convention proposed the establishment of a registered charitable organisation certified by the Council of Europe. Such certified organisations would be treated as charities in all participating states and persons making contributions to such organisations would qualify as contributions to charitable organisations for the purpose of all taxes imposed by the donor's own country. The treaty also made provision for contribution of assets in a third contracting state whether contributed to a local charity or not.

More recently, the Commission of the European Communities has addressed the issue directly in relation to value added tax. Art. 13(a) of the Sixth VAT Directive requires Member States to exempt from VAT the supply of goods and services connected with charities and other activities in the public interest.

VII. CONCLUSION

It is clear that from a taxation point of view, beneficial tax treatment given to contributors of charities and to charities themselves operates almost universally within the boundaries of nation states. An important exception to this does exist in relation to those countries that permit charities to be established whose objects relate entirely to the provision of benefits outside that particular country. Limited extensions of the general principles beyond national boundaries are provided for by way of bilateral treaty. The reasons for this are not difficult to imagine. First, from a policy perspective, no doubt arises from a traditional view that public and community concerns are usually of a local character only. From an economic perspective permitting charitable deductions for foreign charities constitutes a clear transfer of wealth from one country to another subsidised by the government of the transferor in the form of revenues foregone. Thus, countries will want to place some limitations on this particular outflow of funds. Thus, for non-tax reasons, governments may prefer to provide financial assistance in other countries in the form of government sponsored charity rather than privately directed contributions. From a tax point of view, there is the concern that abuses will occur and that tax evasion may be facilitated by bogus charities, particularly in those countries

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that have limited capacity to supervise charities and to monitor their activities, or the requirements to qualify as a charity may differ sufficiently, resulting in perceived abuses such as benefits being returned to the donors in one form or another. Finally, there must be the political concern that what may be regarded as charitable in one country may be regarded as political in another.

Notwithstanding all of these traditional concerns, there is no doubt that in present times, charities have become more international. Increase in cross-border contributions and cross-border activity by charities is inevitable. On the humanitarian level, increased public awareness of events in other countries has given rise to charities such as the Band Aid Trust, whose objects are entirely in Africa but which raised £ 15,000,000 in the United Kingdom alone in 1986. Other traditional areas of charitable activities, such as scientific research, are becoming more international with institutions and individuals competing internationally for resources, as well as benefiting people in many countries by their research, and even licensing technology to various countries. Education is similarly becoming internationalised with people studying at every level at foreign institutions as a matter of course.

These developments make it imperative that new initiative be taken to deal with these issues. The following proposals if submitted will make a substantial contribution towards encouraging international philanthropy.

Recognition of foreign charities generally should not be a matter of domestic law. There should be some element of mutuality in this regard. With the possible exception of the European Community, it seems unlikely at this time that any multilateral attempts at extending beneficial tax treatment for charitable donations and charitable organisations is likely to be achieved. The best prospect in this regard is by way of bilateral treaty.

IFA NEWS

FRENCH BRANCH

On 10 October 1989 the Board of Directors of the French Branch of IFA met to discuss matters of general importance. The President, Mr. Guy Delorme, welcomed Mr. Michel Taly who was recently made Director of the "Service de la législation fiscale" and who will be an associate member of the Board, like Mr. Lemierre who was recently appointed as Director General Taxation. The Board noted with satisfaction that close to 100 French members attended the IFA Congress in Rio de Janeiro. Mr. Delorme chaired the panel on the subject of the administrative and compliance costs of taxation. During the IFA Congress in Stockholm, a French representative will participate in the panel discussion on mutual administrative assistance and exchange of information.

On 21 November 1989 the General Assembly of the French Branch will convene in Hotel Royal Monceau, 35 Avenue Hoche, Paris preceding a seminar on taxpayers' grievance actions.

The next meeting of the Board of Directors has been scheduled on 13 February 1990 in the ANSA building.

HONG KONG

The Second Regional Congress to be held from 22-24 November 1989 in Hong Kong has been cancelled due to an insufficient number of foreign registrants.

U.S.A. BRANCH

On 13 September 1989, the Mid-Atlantic Committee discussed the technical programme for the 1990 National Meeting of the U.S.A. IFA Branch. A follow-up meeting was scheduled for 1 November 1989. Subjects which were contemplated included: the exchange of information, treaty negotiation policy, transfer of intangibles, hedgeing, foreign currency and foreign tax credit.

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Gifts without Borders:

U.S. Tax Treatment of International Charitable Contributions

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I. INTRODUCTION

A. Overview of the "charitable" sector in the U.S. economy

The practice of attending to community needs through non-governmental mechanisms is basic in American society. In the United States there are great numbers of schools, hospitals, churches, museums, social welfare agencies and other charitable institutions which have no formal governmental affiliation. These institutions are supported in large part by charitable contributions from individuals and corporations.

In 1988, individuals donated US$ 86.7 billion in charitable contributions; charitable bequests from estates totalled $ 6.2 billion; and charitable contributions by corporations amounted to $ 4.7 billion.[1] During that same period, individuals contributed volunteer services valued at many billions of dollars, but for which no charitable contribution deduction is allowed.[2] Although the charitable sector is very large and somewhat independent of government, throughout American history the various levels of government have encouraged the growth of charitable organizations and charitable giving through the tax laws.

Exemption from property taxes is one of the major immunities enjoyed by non-profit organizations engaged in charitable activities. Today, all states have some form of property tax exemption for non-profit charitable organizations. Non-profit charitable organizations generally are exempt from state and federal income taxes. The federal income tax exemption for religious, educational, artistic, scientific, social welfare organizations, and other charitable organizations has been in existence since the first basic income tax was introduced in the late 1800s.[3] Another significant tax benefit for the charitable sector of the American economy is the income tax deduction for charitable contributions.[4] Charitable contributions also usually are deductible in computing state and federal gift[5] and death[6] taxes.

B. Overview of the income, gift and death tax treatment of charitable contributions

Individuals and corporations generally are allowed a federal income tax deduction for gifts of cash and other property to charitable organizations.[7] This general statement, however, is subject to several qualifications such that the determination of whether a charitable contribution deduction is available in a particular instance depends on the following 3 questions:

(1) Is the donee organization a qualified recipient for purposes of the income tax charitable contribution deduction?[8]
(2) Does the nature of the property interest given preclude a charitable contribution deduction[9] or require a reduction in the amount of the deduction?[10]
(3) Do the ceilings on the amount deductible keep the donor from obtaining the full deduction in the year the gift is made?[11]

Charitable contributions made by individuals also may be deductible for federal gift tax purposes.[12] The gift tax deduction, however, is somewhat broader than the federal income tax deduction for charitable contributions.[13] As a result, contributions by individuals that

1. "Donations last year topped $ 100 billion," *Insight* (3 July 1989) at 47. The income tax deduction for charitable contributions by individuals and corporations is estimated to have reduced federal government revenues by more than $ 11.7 billion. *Special Analyses, Budget of the United States Government, Fiscal Year 1988* at G-44.
2. A deduction may be allowed for unreimbursed expenditures made in connection with donated services. For example, the cost of a required uniform, such as for a hospital volunteer, or out-of-pocket transportation expenses incurred while donating services, are deductible. U.S. Treasury Regulation Sec. 1.170A-1(g). (U.S. Treasury Regulations are hereafter referred to as "Reg.") However, no deduction is allowed for travel expenses if the travel includes a "significant element" of personal pleasure. U.S. Internal Revenue Code of 1986 Sec. 170(k). (The U.S. Internal Revenue Code of 1986 is hereafter referred to as "IRC.")
3. IRC Sec. 501(a), (c), (d). The charitable contribution deduction originated in the 1894 income tax statute, the Tariff Act of 1894, Sec. 32. The law itself was declared unconstitutional in 1895; the Sixteenth Amendment of the United States Constitution permitting an income tax and the Revenue Act of 1913 reestablished the income tax and with it the deduction for charitable contributions. B. Hopkins, *The Law of Tax-Exempt Organizations* (1987) at 4-5.
4. IRC Sec. 170(a).
5. IRC Sec. 2522(a).
6. IRC Sec. 2055(a)(2), (3).
7. IRC Sec. 170(a)(1).
8. IRC Sec. 170(c).
9. IRC Sec. 170(f).
10. IRC Sec. 170(e)(3)(B).
11. IRC Sec. 170(d).
12. IRC Sec. 2522.
13. The gift tax deduction, for example, does not have the territorial restrictions contained in the income tax deduction. Cf. IRC Sec. 2522(a) with IRC Sec. 170(c).

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qualify for the income tax deduction also qualify for the gift tax exemption, although the converse is not necessarily true. This means that most tax planning involving charitable contributions by individuals is focused on the income tax requirements rather than the gift tax provisions. As to corporations, since the gift tax generally does not apply to charitable contributions by publicly traded corporations,[14] tax planning involving gifts by such corporations usually is done just by reference to the income tax requirements.[15]

Charitable gifts made at death usually are deductible for federal estate tax purposes. The estate tax deduction is similar to the gift tax deduction in that it is broader than the income tax deduction.[16] Since the federal estate tax threshold is now set at $ 600,000,[17] the estate tax charitable contribution deduction is of diminished importance. For wealthy individuals, however, the estate tax charitable contribution deduction remains a significant device for reducing the federal death tax burden.

Many of the states in the United States also have their own income, gift and death taxes. Although there is considerable variety in the form and rate of these taxes, the states usually treat charitable contributions in a fashion somewhat similar to the federal tax treatment.

II. WHO ARE QUALIFIED RECIPIENTS FOR PURPOSES OF THE INCOME TAX CHARITABLE CONTRIBUTION DEDUCTION?

A. Identifying qualified recipients

In order to be a qualified recipient for purposes of the income tax charitable contribution deduction, the donee organization must be a non-profit corporation or trust that is engaged in charitable activities.[18] The process of becoming a qualified recipient begins with the formation of the organization as a non-profit corporation or trust under the laws of a particular state. These non-profit corporation and trust laws generally require that the assets of the organization and the income from the organization's operations be devoted to public or charitable purposes in perpetuity. On dissolution of a non-profit corporation, for example, the assets of the corporation must be transferred not to the individual incorporators but to another non-profit organization.

As the non-profit organization is being formed, the organization generally must apply to the U.S. Internal Revenue Service for tax-exempt status.[19] Being granted tax-exempt status, however, does not necessarily make the organization a qualified recipient of charitable contributions since tax-exempt status is available for a wide range of non-profit organizations that are not engaged in charitable activities. The U.S. Chamber of Commerce, the League of Women Voters, the American Medical Association, the American Bar Association, most labor unions and social clubs and similar organizations are exempt from the federal income tax, but they are not qualified recipients of charitable contributions.

Only non-profit organizations engaged in charitable activities are qualified recipients of charitable contributions.[20] Thus, the following qualify to receive charitable contributions:

- a state, a possession of the United States, or any political subdivision of a state or possession, and the United States;[21]
- religious, charitable, scientific, literary, and educational organizations;[22]
- organizations formed to promote national and international amateur sports events;[23]
- organizations for the prevention of cruelty to children or animals;[24]
- posts or organizations of war veterans;[25]
- cemetery corporations;[26] and
- in certain instances, domestic fraternal societies operating under a lodge system.[27]

A large number of the qualified charitable organizations are well-known to the general public. There are, however, many other non-profit exempt organizations whose status as qualified recipients is not widely known. As a result, to assist the public in identifying qualified charitable organizations, the Internal Revenue Service annually publishes an updated list of qualified recipients in the *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986.*

B. Special restrictions on the political activities of charitable organizations

In addition to being organized as non-profit institutions and engaged in charitable activities, charitable organizations are required by the U.S. tax laws not to be heavily involved in political activities.[28] This means that charitable organizations are prohibited from participating in elections and may not be actively involved in attempting to influence legislation.

C. Taxes on charitable organizations

Even "tax-exempt" charitable organizations are potentially liable for certain taxes. Charitable organizations (and other tax-exempt organizations) that en-

14. Reg. Sec. 25.0-1(b).
15. As for gifts by closely held corporations, the gift tax commonly imputes the gifts to the individual shareholders with the tax consequences dependent on how such gifts would have been treated if made directly by the individual shareholders. Reg. Sec. 25.2511-1(h)(1).
16. As with the gift tax deduction, for example, the estate tax deduction does not have the territorial limits of the income tax deduction. Cf. IRC Sec. 2055(a) with IRC Sec. 170(c).
17. IRC Sec. 2010.
18. IRC Sec. 170(c).
19. IRC Sec. 508(a); Reg. Sec. 1.501(a)-1(a)(3)(i). Revenue Procedure (Rev. Proc.) 84-46 gives detailed instructions for the application process. See 1984-1 Internal Revenue Service Cumulative Bulletin (hereinafter referred to as "C.B.") 541.
20. IRC Sec. 170(c).
21. IRC Sec. 170(c)(1).
22. IRC Sec. 170(c)(2)(B).
23. Id.
24. Id.
25. IRC Sec. 170(c)(3).
26. IRC Sec. 170(c)(5).
27. IRC Sec. 170(c)(4).
28. IRC Secs. 170(c)(2)(D) and 501(c)(3).

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gage in "unrelated businesses"[29] lose their tax-exempt status with respect to the income from the unrelated businesses.[30] Examples of unrelated business activities of charitable organizations are the following:

- operation of a commercial radio station by a university[31]
- operation of an orchard by a charitable trust;[32]
- maintaining a mailing service for other charitable organizations;[33]
- sales of scientific books and city souvenirs by a museum of folk art;[34]
- sales of blood and blood plasma by a community blood bank to commercial enterprises;[35]
- commercial operation of a miniature golf course by a youth organization;[36] and
- travel tour programs operated by university alumni groups.[37]

Although all qualified recipients have to be charitable organizations, the tax law further differentiates between "public" charities and "private foundations", with the former receiving more favoured tax treatment than the latter. Public charities generally are non-profit, charitable organizations that are either directly involved in charitable activities or else draw their support from the public at large. Non-profit schools, such as Harvard, Stanford and Columbia, are public charities because they are directly engaged in educational activities. The United Way, which is essentially a grant-making organization, also is a public charity because it draws its support from large numbers of relatively small contributions.

Private foundations are charitable organizations that draw their support from only a few sources, such as a single family or corporation, and are not directly involved in charitable activities. The Rockefeller and Ford Foundations, for example, derived the bulk of their assets from the families after which they are named, and, as they are not directly involved in the operation of a school, hospital, church or museum, they are characterized as private foundations.[38]

29. IRC Sec. 513(a).
30. IRC Sec. 511(a).
31. Revenue Ruling (Rev. Rul.) 55-676, 1955-2, C.B. 266.
32. Rev. Rul. 58-482, 1958-2 C.B. 273.
33. Rev. Rul. 68-550, 1968-2 C.B. 249.
34. Rev. Rul. 73-105, 1973-1 C.B. 264.
35. Rev. Rul. 66-323, 1966-2 C.B. 216, modified by Rev. Rul. 78-145, 1978-1 C.B. 169.
36. Rev. Rul. 79-361, 1979-2 C.B. 237.
37. Rev. Rul. 78-43, 1978-1 C.B. 164.
38. IRC Sec. 509(a).
39. IRC Sec. 170(b)(1)(A).
40. IRC Sec. 170(b)(1)(B).
41. IRC Sec. 170(d)(1).
42. IRC Sec. 4940(a).
43. See, e.g. IRC Sec. 4945(d)(3) and (g).
44. IRC Sec. 170(b)(1)(A).
45. IRC Sec. 170(b)(1)(B).
46. It is commonplace in the United States for businesses to contribute to charities for the purpose of enhancing their image in the community. The enhanced image, it is thought, may lead to an increase in business profits; but so long as the connection between the contribution and the possibility of increased business profits is indirect, the contribution is deductible.
47. Reg. Sec. 1.170A-(1)(g). But see supra note 2.

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The favoritism accorded public charities is reflected most clearly in the limits on the income tax charitable contribution deduction. Although there are a number of exceptions and special rules, contributions by individuals to public charities are deductible up to 50% of the individual's net income.[39] Contributions to private foundations, however, may not exceed 30% of the individual's net income.[40] In addition, in the case of 50% charities, contributions in excess of the 50% limitation may be carried forward for up to 5 years.[41]

Private foundations are also subject to a number of excise taxes. Private foundations that are not directly involved in charitable activities are subject to a 2% excise tax on their net investment income.[42] Various excise taxes are imposed as penalties for the use of the assets of private foundations in certain ways. If, for example, a private foundation makes a travel grant to an individual and it does not closely monitor the use of the grant proceeds, the foundation may have to pay an excise tax up to the amount of the travel grant.[43]

III. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

The income tax treatment of charitable contributions depends not only on the nature of the recipient organization but also on the nature of the gift.

A. Distinctions based on the nature of the recipient

As discussed in section II, above, contributions to non-profit organizations are deductible provided that the organization meets the requirements set out in the U.S. Internal Revenue Code. The maximum amount of the contribution deduction in a particular year depends on whether the recipient is a public or a private charity. For gifts to public charities, the ceiling on deductible contributions is generally 50% of the individual donor's net income.[44] For private foundations, the ceiling generally is 30% of the individual donor's net income.[45]

B. Distinctions based on the nature of the gift

A threshold requirement for contributions to be deductible is that they be given with a donative intent. In other words, the contributions must not be designed to achieve some ulterior motive, such as to benefit some close relative or to directly increase business.[46] For the purposes of this article, it is assumed that the charitable contribution is a legitimate gift and not a subterfuge for some other, non-qualifying transaction.

For income tax purposes, the amount of a charitable contribution is the amount of cash or the fair market value of other property irrevocably given to charitable organizations. No deduction is allowed for the value of services performed for charitable organizations.[47]

In the case of gifts of property other than cash, the tax laws impose a number of restrictions. If a sale of the

gift property would have produced ordinary income, then the charitable contribution deduction has to be reduced by the amount of the ordinary income.[48] Thus, if an individual gives an item of inventory to a charitable organization, the charitable contribution deduction is limited to the individual's cost of the inventory rather than the fair market value of the inventory. This rule has an enormous impact on potential charitable gifts by artists since the rule reduces the artists' charitable contribution deduction to zero for gifts of their own art work.[49]

Gifts of appreciated stocks and bonds are attractive because the sale of the stocks and bonds usually produces capital gains instead of ordinary income. As a consequence, in many instances, gifts of stocks and bonds generate an income tax deduction equal to their fair market value rather than their cost. In 1986, however, the difference between cost and fair market value of stocks, bonds and other capital assets was made subject to the alternative minimum tax on individuals and corporations.[50] As a result, large gifts of appreciated capital assets may not generate as great a tax benefit as they once did.

Since the amount of the charitable contribution is generally determined by reference to the fair market value of the property at the time of the gift, in instances in which the property has declined in value such that its tax basis is higher than its value, the donors often have an incentive to sell the property, realize the loss, and then donate the proceeds of the sale, rather than making a direct gift of the depreciated property. Gifts of remainder interests in trust are quite common in the United States. A typical gift would reserve for the donor the income for life, with the remainder passing to the charity on the death of the donor. The advantage of this type of gift is that the donor gets an immediate income tax deduction for what is essentially a gift deferred to the donor's death. In order to qualify for an income tax charitable contribution deduction, however, the trust must meet several specific requirements as a charitable remainder annuity trust, charitable remainder unitrust, or pooled income fund.[51]

The United States also recognizes the dedication of property to conservation purposes as giving rise to a charitable contribution deduction. In order to qualify, however, the donor must irrevocably dedicate the property to conservation purposes, such as by transferring to a charitable organization a conservation easement under which development is forbidden.[52]

C. Ceilings on the charitable contribution deduction

The amount of the charitable contribution deduction allowed in any year is generally based on the value of cash and other property given to charitable organizations during the year. The deduction is, however, also subject to limitations which are stated as a percentage of the donor's net income. The primary percentage limitation applicable to individuals is that contributions may not exceed 50% of the individual's net income for the year.[53] In the case of contributions of appreciated property such as stocks and bonds to public charities, or in the case of cash contributions to private foundations, the contributions generally may not exceed 30% of the individual donor's net income.[54] The percentage limitation applicable to corporate donors is 10% of the donor's net income for the year in which the contribution is made, irrespective of the status of the donee or the nature of the property interest given.[55]

For individual donors, contributions to public charities which are not deductible because they exceed the applicable percentage limitations in a particular year usually qualify for a 5-year carry-forward.[56] Excess contributions by corporations also qualify for the 5-year carry-forward whether the contributions are to public charities or to private foundations.[57]

IV. TERRITORIAL LIMITS ON QUALIFYING ORGANIZATIONS

A. The income tax charitable contribution deduction

For individual donors, qualified charitable organizations must be created or organized in the United States or its possessions.[58] Although this condition means that contributions to foreign charities are not deductible, the deduction is allowed when it is made to a U.S. charity for use abroad by that charity. Thus, a domestic organization formed to deal with the problem of plant and wildlife ecology in a foreign country may be a qualified charity.[59] Similarly, a non-profit educational organization created in the United States to operate a school in Paris is a qualified recipient.[60] A deduction will be allowed even when the domestic charity's work is carried out under the auspices of a foreign subsidiary, provided that the charity established the subsidiary to expedite its administration of charitable works in the foreign country.[61]

When a U.S. charity raises money specifically for use by a foreign charity, the tax treatment of the deduction depends on the control and oversight that the U.S.

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48. IRC Sec. 170(e)(1)9(A).
49. IRC Sec. 1221(3)(A), 170(e). This rule affects any taxpayer "whose personal efforts created" the donated property. Thus, in *James H. Morrison,* 71 T.C. 683, *aff'd* 611 F.2d 98 (5th Cir. 1980), a former Congressman was not allowed to take a deduction for his personal letters that he donated to a charitable organization.
50. IRC Sec. 57(a)(6).
51. IRC Sec. 170(f)(2)(A).
52. IRC Sec. 170(f)(3)(B)(iii) and (h)(1).
53. IRC Sec. 170(b)(1)(A).
54. IRC Sec. 170(b)(1)(B), (C).
55. IRC Sec. 170(b)(2).
56. IRC Sec. 170(d)(1).
57. IRC Sec. 170(d)(2).
58. IRC Sec. 170(c)(2)(A).
59. Rev. Rul. 75-65, 1975-1 C.B. 79.
60. *Bilingual Montessori School of Paris, Inc. v. Commissioner,* 75 T.C. 480 (1980).
61. Rev. Rul. 63-252, 1963-2 C.B. 101.

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charity retains on the distribution of the funds. A deduction will not be allowed for a contribution to a U.S. organization that raises funds for a foreign charity when it is required (by its charter, for example) to contribute all or a particular portion of the funds to the foreign charity. In relinquishing control to the foreign organization over the use of the funds, the U.S. charity is viewed as a mere conduit for the actual recipient, the foreign organization. A deduction is not permitted because the contribution is viewed as equivalent to making a contribution directly to the foreign charity. Likewise, donations given to a usually qualifying U.S. charity in response to its fund-raising campaign held by agreement with and for the benefit of a foreign organization will not be deductible. Such donations are regarded as being designated for the foreign organization ("earmarked") and thus they are out of the control of the U.S. charity. Although the charity's sole function is not to be a fund-raising arm of the foreign organization as in the previous case, this specialized fund-raising role has the domestic charity functioning essentially as a conduit of funds for the foreign charity; thus, a deduction is not permitted.[62]

In contrast, a deduction is allowed when the role of the U.S. charity is significantly more than that of a nominal donee. When the charity has reviewed and approved a specific project of a foreign organization and has determined that the project furthers its own charitable purposes, then it may both raise funds for the project and give grants to the foreign organization to carry out the project without impairing the deductibility of a donation. The key to the different treatment is the charity's having full control of the donated funds and discretion regarding their use. (These restrictions on the charity's solicitation and disbursement of funds would be set forth in its bylaws.)[63]

In the case of contributions by corporations, the tax law makes an artificial distinction between charitable corporations and other charitable organizations. If the recipient is a charitable corporation organized in the United States or its possessions, then the contribution is deductible even though it is used abroad.[64] If the recipient is not a corporation, but is a charitable trust or other charitable organization, then the deduction is allowed only if the organization was created or organized in the United States or its possessions and the gift is used within the United States or its possessions.[65]

B. The gift tax charitable contribution deduction

For resident individuals and U.S. citizens, there are no territorial limits on the gift tax charitable contribution deduction. On the other hand, there are some territorial restrictions on the gift tax charitable contribution deduction available for non-resident aliens, but as to such individuals, the U.S. gift tax has very limited significance.

C. The estate tax charitable contribution deduction

For resident individuals and U.S. citizens, there are no territorial limits on the federal estate tax charitable contribution deduction.[66]

V. THE IMPACT OF TAX TREATIES

In general, the United States has resisted efforts to expand the availability of the income tax charitable contribution deduction. In the recent treaty negotiations with Barbados, for example, the United States declined to include Barbadian charities as qualified recipients for U.S. income tax purposes.

In its income tax treaty with Canada, however, the United States agreed to a limited extension of the charitable contribution deduction. Under the U.S.–Canada treaty, contributions by U.S. residents and citizens to Canadian charities are deductible for purposes of U.S. income tax. The deduction is limited to the amount of the donor's Canadian-source income[67] and must be within the percentage limitations for deductible contributions specified by the U.S. Internal Revenue Code.[68]

The U.S. income tax treaty with Israel, not yet in effect, also provides that contributions by U.S. residents and citizens to Israeli charities will qualify for the U.S. charitable contribution deduction. The deduction is limited to 25% of the donor's Israeli-source income and must also not exceed the maximum percentage allowed by the Internal Revenue Code for charitable deductions.

When the U.S.–Israel treaty is ratified, there will be a 30-day period, beginning on the date of ratification, before the treaty becomes effective. Since the treaty is not yet a binding agreement, at the present time a contribution made by a U.S. citizen from the citizen's Israeli-source income to an Israeli charitable organization is not deductible nor is there a possibility for retroactive deductibility of the contribution given before the treaty's effective date. Until the income tax treaty is ratified, a U.S. taxpayer who wishes to take a deduction for a contribution to an Israeli charitable cause is advised to locate a domestic qualifying recipient that does charitable works in Israel.

62. Id.
63. Rev. Rul. 66-79, 1966-1 C.B. 48, amplifying Rev. Rul. 63-252, 1963-2 C.B. 101.
64. Rev. Rul. 69-80. 1969-1 C.B. 65.
65. IRC Sec. 170(c)(2).
66. Rev. Rul. 74-523, 1974-2 C.B. 304.
67. Rev. Proc. 59-31, 1959-2 C.B. 949.
68. Contributions by individuals to public charities are deductible up to 50% of the individual's adjusted gross income. IRC Sec. 170(b)(1)(A).

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International Tax Aspects of Charitable Giving and Philanthropic Organisations:

English Law and Practice

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I. PURPOSE AND SCOPE

A wide variety of non-profit making organisations and entities exist under the law and in practice in England.

These include:

- entities which, for most practical purposes, can be seen as commercial, such as agricultural or industrial cooperatives or mutual life insurance societies;
- funds which themselves are non-commercial but which exist in a commercial context, such as pension and superannuation funds, or compensation funds (e.g. the Solicitors' Compensation Fund for the protection of members of the public who lose money from a dishonest solicitor), or trusts for the employees of a company;
- associations for collective recreation or self-improvement, e.g. sports clubs, philosophical or cultural societies;
- charitable trusts and foundations, in all their variety, which are the subject matter of this article; and finally
- funds which have a family connection. These, too, have an immense variety, ranging from funds for the maintenance of historic houses or pieces of outstanding landscape owned by an individual or a family, but which the public are about to visit to a variety of family trusts and settlements, often for very wide classes of beneficiaries including people outside the family, such as employees of the family or of family companies jointly with the family; and trusts solely for the benefit of one or 2 members of a family.

Not only is the variety great, but correspondingly entities within this wide variety exist in immense number in England. The value of assets – land, buildings, government securities, shares in public companies or private companies owned by these entities is of great worth.

The purpose of this article is to review charitable or philanthropic organisations. The word "philanthropic" is not a word which is used with any particular legal significance in English law, and accordingly this paper will consider "charities". In the English language, "charity" can have a narrower and a wider meaning. Its narrower and non-legal meaning implies a distribution of food or money from the wealthy to the poor, and in that context has historical and religious associations. The word is widely understood by ordinary people in England in this sense. The word also, however, has a wider and legal meaning, and that, of course, is the meaning in which it is used in this article.

"Charity" is not defined by any statute in force in England. Although this is a deficiency which is much criticised – and suggestions have frequently been made that there should be such a definition – the difficulty of creating a statutory definition is seen as being the way in which new charitable activities rapidly evolve in England and need to be accommodated within the legal and fiscal definition of charity. The advantage, therefore, which is seen in not having a precise definition is in preserving flexibility. For this reason, we look in England to case law to find precedents either for a decision as to whether the use of particular words is charitable or for guidance as to general approach and intent. A classification of the case law was made in a leading case in 1891: *Commissioners for Income Tax v. Pemsel,*[1] and that classification is set out below. That case was influenced by the introductory (but non-legislative) words of a Statute of 1601 (now repealed). The words of the Statute are worth quoting as representing, still, a broad and representative selection of activities which will, in modern law, be regarded as charitable: "The relief of aged, impotent and poor people; the maintenance of sick and maimed soldiers and mariners, schools of learning, free schools and scholars in universities; the repair of bridges, ports, havens, causeways, churches, seabanks and highways; the education and preferment of orphans; the relief, stock or maintenance for houses of correction; the marriage of poor maids, the supportation, aid and help of young tradesmen, handicraftsmen and persons decayed; the relief or redemption of prisoners or captives; and the aid or ease of any poor inhabitants concerning payment of .... taxes".

A charitable trust must be wholly and exclusively charitable (and not, therefore, partially so). There

1. (1891) *Appeal Cases* (AC) 539.

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must be the requisite element of public benefit, i.e. it must be for the benefit of the community at large, or a sufficiently important section of the community, not being a section solely defined by means of a relationship of employment, or of family kinship.

The classification in the case of *Commissioners for Income Tax v. Pemsel* as to recognised areas of charitable activities was as follows:
- trusts for the relief of poverty,
- trusts for the advancement of education,
- trusts for the advancement of religion, and
- trusts for other purposes beneficial to the community.

Since *Pemsel* was decided, a distinct sub-category has emerged (which is seen as forming part of this category), namely recreational and sporting charities. Such purposes can only be charitable under limited circumstances, and most sporting associations will be non-profit making non-charities.

II. LEGAL ENTITIES

An entity, a purpose or even a person, may be charitable within the above classification. There is no single specified method of constituting a charity. Equally – with the one important exception of registration, noted below – there is no simple way of immediately recognising a charity. The examples of legal entities which may be charities are:

A. *Charitable trusts*

B. *Charitable companies incorporated under the Companies Acts*

Such companies are registered under the same Companies Acts as commercial companies, but it is their objects which distinguish them. Their constitution (Memorandum and Articles of Association) may be one of a variety of types, from companies which are under the self-perpetuating control of a group of "trustees", to those which are under the control of a large membership of individuals who subscribe to the objects of the charity and become "members" of the company. It is permissible for non-profit making companies to omit the word "limited" at the end of their registered name.

C. *Charitable companies incorporated by Royal Charter*

This is a form of incorporation which has great prestige and is, of course, distinct from the legal structure of those companies which are formed under the ordinary Companies Acts. This is a form of incorporation used by some of the oldest or most distinguished of charities.

D. *Unincorporated associations*

Such associations have no legal personality under English law and have limited liability. Nevertheless, if their purposes and activities are appropriate, they can be charities.

E. *Appeal funds* (discussed below)

III. OFFICIAL CONSENTS AND REGISTRATION

There is no requirement for any form of official consent for the creation of a charity. There is, however, a requirement of registration, for all but the smallest charities. Under the Charities Act 1960, it is necessary for a charity to be registered with the Charity Commission, a public body which has minor judicial and important administrative functions. Registration is free, and is given in respect of any entity which is considered to be charitable within the headings noted above. There is a right of appeal against refusal of registration to the High Court. Registration is conclusive evidence as to charitable status. In practice, the Charity Commission always consults the Inland Revenue before allowing registration. There is no separate fiscal test as to a charitable status, but it is possible that the Inland Revenue are more effective in their control of charities than the Charity Commissioners, because not only do they examine applications for registration, but also consider the tax affairs of charities on a regular basis (which the Charity Commission generally does not).

In practice, the simplest way of recognising a charity in England (but not Scotland) is to ascertain whether it has a registered charity number. Certain charities are exempt or excluded from registration under the Charities Act, e.g. the major private (public) schools, universities and university colleges, the Church of England and other old established churches.

IV. MANNER OF FUNDING AND OPERATING

In England, charities may of course receive their funds in a variety of ways. At one extreme, some charities are merely a repository of wealth, the income from which is available to pay to other "active" charities or purposes. At the other extreme, there are charities possessed of no funds of their own, but who live from hand to mouth, making requests for funds or receiving grants, to enable them to pursue the humane activities for which they were founded. With one recent exception (noted below) there is no fiscal distinction under this heading. There is, however, a distinction of charity law made between an "endowed" charity and a non-endowed charity. The former has capital which must not be spent but must be held by the trustees in perpetuity, and only the income applied for charitable purposes. The non-endowed charity either has no capital or it has capital. If it has, the capital may be as freely spent as its income in pursuit of its charitable objects.

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V. TAX TREATMENT OF GIFTS

There are no restrictions in English law as to the type of property (e.g. land or building or investments) which may be given to charity; nor on the size of the gift. It is also worth mentioning, in this context, that there is no direct equivalent under English law to the reserved rights of inheritance of children under most civil law systems.

Gifts may be made by outright gift, by the establishment of a trust or by will.

Gifts, whether made during a person's lifetime or on death, enjoy the following tax privileges:

A. *Income tax*

A single gift, even if made out of the donor's income, does not enjoy any income tax privileges.

Conversely, a series of regular gifts made out of the donor's income under a "deed of covenant" is privileged, and the receiving charity is entitled to reclaim the income tax referable to the payment which the donor has paid. A deed of covenant is a promise to pay annually a defined sum of money – and for it to be effective in this context, it must be for a period of not less than 3 years (in practice the usual minimum period selected is 4 years).

"Payroll deduction": there is an arrangement by which an employer may set up a scheme, by which his employees may, if they wish, contribute a small sum each year to a collective charitable collecting agency and these gifts qualify for income tax relief.

B. *Corporation tax*

Corporation tax is charged on the profits of U.K. resident companies (and on U.K. resident unincorporated associations' taxable profits). Thus, single gifts are not, in principle, tax-deductible, unless – as may often be the case – they can be classified as business expenses for the benefit of the company's trade and the earning of the profits. An equivalent of deed of covenant exists for companies making gifts to charity.

C. *Capital gains tax ("CGT")*

The disposal, including by way of gift, of an asset is, in principle, chargeable to CGT in the United Kingdom. In the case of a gift to charity, no such tax is charged. The charity will be treated as having acquired the asset at the same price as the donor acquired it, for tax purposes, and if the asset is subsequently disposed of by the charity, the whole gain – including the gain referable to the period of ownership by the donor – will be exempt.

D. *Inheritance tax ("IHT")*

All gifts made during a person's lifetime or on death to a charity are exempt from inheritance tax, provided that the donor or his family retain no benefit from the gift, and that the property so given is held in exclusively charitable trusts and cannot be withdrawn from charitable purposes and applied for private benefit.

There are provisions by which the payment of IHT may be made in the form of exceptionally important works of art or historic buildings, in which case these, after having been accepted by the State, would normally be made available for public viewing, under the supervision of a national charity.

E. *Stamp duty (or registration duty)*

No stamp duty or other similar duty is charged on gifts or transfers of property to charity.

VI. TAX TREATMENT OF CHARITIES

Charities enjoy the following tax privileges:

A. *Income tax*

A charity is exempt from income tax on its income, provided the income is "applicable and applied" to charitable purposes. The exemption extends to permitting a charity to reclaim tax deducted at source, e.g. the advance corporation tax imputed to a dividend paid by a U.K. company.

If a charity conducts a trade with a view to generating income for its charitable purposes, the trading income will, in general, be taxable unless:

- either the trade is carried on in the course of the actual undertaking of a primary purpose of the charity, *or* the work in connection with the trade is mainly carried out by beneficiaries of the charity, *and*
- the profits are applied solely for the purposes of the charity.

The former test will exempt, for example, schools and university colleges, and the latter test will exempt factories for handicapped people, or even a music festival. The above exemptions do not, therefore, apply to 2 significant areas of charitable trading in England. It is common for charitable or voluntary organisations to raise funds by means of social events or sales (known variously as "bazaars", "fêtes" or "sales of works"). These are exempted from income tax by administrative concession. Secondly, it is common for some of the largest charities to run permanent trading activities either by operating specialist shops (which is done, for example, by the National Trust and Oxfam) or by selling products, particularly Christmas cards and other forms of stationery. To obtain a tax exemption on these profits, it is necessary for the charity to form a subsidiary company (within the scope of corporation tax) and for the profits of that company to be transferred to the charity either by deed of covenant, or by declaration of dividend, in such a way as to enable the charity which is exempt from tax on its investment income to reclaim the tax. Although such arrangements are designed to circumvent the law, they will be tolerated by the Inland Revenue in cases which are considered to be genuine: for example, one require-

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ment is that it should be the charity which controls the trader and not vice versa. In 1986, further restrictions on the exemption from income tax of charities were imposed in order to prevent charities from merely accumulating tax-exempt income.

Their effect is to deny a charity exemption from income tax on capital gains tax if it has a specified amount of income on gains, and does one or more of the following:
- uses its funds for non-charitable expenditure,
- makes payments to overseas bodies, without taking reasonable steps to ensure that the money is used for charitable purposes, or
- lends or invests in ways which it cannot show are for the benefit of the charity rather than for tax avoidance.

B. *Capital gains tax ("CGT")*

Charities are exempt from CGT in respect of capital gains which they realise on property belonging to them. As noted above, this extends to gains which accrued while a donor had ownership of transferred property by way of gift to a charity.

C. *Inheritance tax ("IHT")*

Other forms of trusts are subject to IHT either by reference to the death of a donor of property, or of a beneficiary of the trust. They may also be subject to IHT on a periodic basis. Charitable trusts are exempt from these charges.

D. *Value added tax ("VAT")*

Charities are not exempt from VAT.

E. *Rates (municipal property taxes)*

Charities are entitled to claim relief from rates in respect of buildings and land which they occupy for charitable purposes, and accordingly to pay half (or less) of the amount which would otherwise be due.

F. *Other taxes*

There is no wealth tax in the United Kingdom, or other tax which would be relevant to a charity. A charity must, however, pay National Insurance contributions in respect of the salaries of its employees, in the same way as any other employer. National Insurance contributions pay for health and welfare services, and although collected by the Inland Revenue, are passed to the Department of Health and Social Security, and not classified as a tax.

VII. TAX TREATMENT OF RECIPIENTS OF FUNDS FROM CHARITIES

There are few clear statutory provisions on this subject. However, the practice can be summarised as follows:

A. *Gifts, donations and grants by a charity*

There is no liability on a charity making such a payment to deduct tax.

B. *Receipt of a donation, gift or grant by an individual who is an object of charity (or a beneficiary of the charity)*

Gifts are not treated as income, and therefore are not subject to income tax in the hands of the recipient. However, regular and predictable payments which cease to have the character of gifts would probably be within the scope of income tax in the hands of the recipient.

C. *Scholarships, prizes, etc.*

These are specifically excluded by statute from liability to income tax in the hands of the recipient. This is not an exemption referable to charities, but to the recipient.

D. *Salaries of employees of charities*

Apart from certain minor advantages in respect of benefits of employment, employees of charities are liable to income tax on their salaries in the same way as any other employees. This will apply both to, for example, the Director-General of a national charity, or to a priest.

VIII. INTERNATIONAL ASPECTS

A. Foreign activities of English charities

Case law has recognised that the first 3 classifications of charitable activity, i.e. the advancement of religion, the advancement of education and the relief of poverty, are charitable under English law (and therefore qualify for tax privileges) irrespective of wherever in the world they are undertaken. Insofar as the fourth heading of "other purposes beneficial to the community" is concerned, it is necessary to find some benefit to the community in the United Kingdom. This is a very fluid test: it seems to allow any activity which could be described as humanitarian, while not allowing activities which could be classified solely as improving the economy of another country, unless it is possible to see them as relieving poverty – in which case they will be regarded as charitable.

B. English activities of foreign charities

The specific tax privileges, noted above, given to charities are only given to charities which are established under English, or Scottish, law. This was decided in the case of *Camille & Henry Dreyfus Foundation Inc. v. Inland Revenue Commissioners.*[2] Although this appears to be discriminatory, in practice it simply means that a foreign charity which wishes to conduct activities in England will form a subsidiary charity under English law and register it with the Charity

2. (1955) 36 *Tax Cases* (TC) 126; (1956) AC 39; 3 *All English Reports* (ER) 97.

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Commission. So long as its declared objectives, and the manner in which it is conducted, are charitable, there will be no objection that it is wholly controlled by an overseas charity. It is the practice of the Charity Commission to require some measure of territorial control over a charity registered under the Charities Act by, for example, requiring that some of the trustees of an English charity be resident in the United Kingdom.

An overseas charity which is not resident in the United Kingdom or does not carry on trading activities in the United Kingdom, may, of course, be exempt from U.K. taxes to the extent that any other non-resident person is exempt. For example, certain British Government securities are exempt from tax if owned by persons who are not resident and not ordinarily resident in the United Kingdom; similarly, bank deposit interest will be exempt from U.K. tax if received by a non-resident. A foreign charity which owned U.K. land as an investment and sold it at a profit would not be liable to CGT provided it was not resident in the United Kingdom or trading here.

IX. TAX TREATIES

The double taxation treaties concluded between the United Kingdom and the United States, the Federal Republic of Germany and Denmark contain certain limited provisions for the benefit of entities resident in those countries which are not subject to tax there. The U.K.–Republic of Ireland treaty allows Irish charities exemption from tax on U.K.-source income.

It is thought that income payable to a foreign charity by an individual resident in the United Kingdom, under a deed of a covenant lasting for a minimum period of 6 years (being the period applicable to deeds of covenant in favour of persons other than English charities) would give rise to the possibility of a reclaim of the U.K. tax deducted at source.

X. DISASTER APPEALS

Disaster appeals are a quite common occurrence in England. The public will often contribute very large sums of money. In the context of this article, such appeals may be seen under 2 headings:

- appeals for disasters overseas, and
- appeals for disasters within the United Kingdom or the seas around the United Kingdom.

The former case gives rise to no difficulties. The funds will be collected by one of the major English charities (either on its own initiative or in collaboration with a foreign charity established in the country in which the disaster has occurred). The payment abroad will be regarded as charitable, and there is no known case in which the funds transmitted abroad were found to be larger than needed for the relief work.

Appeals in respect of disasters occurring in the United Kingdom or the seas around the United Kingdom have, for more than a century, been fraught with difficulties – some legal and some practical. Some, indeed, have been caused by the generosity of the public and the fact that funds donated have often been greatly in excess of what could reasonably be used to relieve suffering. This may increasingly be the case, in modern times, when it happens that the victims of a disaster or their families have the right to compensation for wrongful death or injury, or are in some way covered by insurance, or benefit under the State scheme for the compensation of victims of criminal injuries.

In legal terms, the difficulties have, essentially, arisen from the question of whether or not the appeal was, or was intended to be, a charitable appeal.

If it was a charitable appeal, this freed the appeal from certain technical problems, and gave the appeal the advantage that established charities could easily make a donation to the disaster appeal, but it limited the manner and extent to which the disaster appeal fund could make payments to victims or their families. They could only, for example, relieve distress or poverty. They could not make substantial grants to make the victims or their families financially independent.

If the appeal was not a charitable appeal, it had to be formulated in words which were appropriate to constitute either a valid private trust or to make it clear that the appeal committee was a "postbox", and that they would transmit all the money received directly to the victims or to their families, with no element of trust or discretion. The need for a precise choice of words to create a valid private trust caused a number of such appeals, in the past, to fail, and accordingly the funds due, in law, to be repaid to the donors.

Recent practice has, however, fortunately largely put an end to this scandal. It is now customary for disaster appeals to be made in accordance with standard forms of words which, initially, give the disaster appeal committee the powers of trustees of a private trust. They may, and now usually do, make substantial distributions to the victims or their families without regard to the limitations of the law of charity. Then, if any surplus funds are left, the disaster appeal is converted into a charity and kept in being for charitable purposes within the locality, or for the benefit of victims of similar disasters in the future; or alternatively, the funds are paid over to an existing charity having similar objects.

The above framework avoids both the problems of invalid trusts and the constraints of charities, but it means that during the period in which the Appeal Committee is exercising its activities, the interest earned on the funds donated is not given the exemption from taxation which it would enjoy if it were a charity.

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INTERNATIONAL:

Charitable Donations and Philanthropic Organisations in Ireland

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I. INTRODUCTION

Broadly speaking charitable activities and donations to charities in Ireland are not liable to any income or capital tax though they may be liable to stamp duty [(unless exempt under Sec. 38 (Stamp Duties (Ireland) Act 1842 (i.e. legacy for charitable purposes)) or under Sec. 50 Finance Act 1979, exempting a conveyance, transfer or lease for charitable purposes to a charitable body in the State (Republic of Ireland) or Northern Ireland] on any stampable instrument, and value added tax on the supply of services to it (though their own activities, insofar as they are philanthropic, will be exempt).

II. SCOPE OF ARTICLE

This article addresses briefly the exemptions and exceptions which apply to charitable donations and the activities of philanthropic organisations in respect of the following taxes:
(1) Capital acquisitions tax (gift or inheritance tax)
(2) Capital gains tax
(3) Income tax
(4) Corporation tax

III. DEFINITIONS

A. "Charitable purpose"

The leading tax case in Ireland on this subject is still the early case of *I.T. Commissioners v. Pemsel,*[1] where Lord Macnaghtan laid down the 4 general categories of charitable purposes:
(1) relief of poverty
(2) advancement of education
(3) advancement of religion
(4) other purposes beneficial to the community not falling within the other 3 categories.

While category "4" will probably be present in almost all cases, it is still not certain in Ireland whether the "public benefit" test is an objective or subjective test. Although the English courts (operating in a jurisdiction where the law in this area is similar) have favoured the objective test, earlier Irish cases held a purpose to be charitable if the donor or settlor believed it to be for the public benefit. This belief had to be rational, legal and moral. The Charities Act of 1961 has not clarified the position by indicating which test should be applied. Sec. 45 of that Act, however, specifically makes valid any gifts for the purposes of advancement of religion (in particular for the celebration of masses) in accordance with the laws, canons, ordinances and tenets of the religion concerned. This section was enacted to eliminate any doubt relating to such gifts, but it applies only after determining whether or not the gift advances religion. There is no indication in the section as to which test should be applied.

B. "Public benefit"

"Public benefit" as a criterion was reviewed by Jenkins, L.J. in *Re Scarisbrick, Cockshott v. Public Trustee.*[2] In order to be charitable, the gift must:
– be for the "benefit of the public" or of "some section of the public";
– not benefit any specific ascertained class or aggregate of individuals (e.g. people related by blood or employment) though there is case law which establishes an exception to this general rule in that trusts or gifts for the relief of poverty have been held to be charitable even though they are limited in their application to some aggregate of individuals ascertained in the manner set out above.

The criterion of "public benefit" does not in itself make the object charitable, and so consideration must

1. (1891) *Appeal Cases* (AC) 539.
2. (1951) 1 *All England Reports* (ER) 822.

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be given to the 4 main categories enumerated by Lord Macnaghton.

IV. CHARITABLE PURPOSES

A. Relief of poverty

"Poverty" has a wide meaning which is well encapsulated by Evershed, M.R. in *Re Coulthurst:*[3] "It is a word of wide and somewhat indefinite import; it may not unfairly be paraphrased for present purposes as meaning persons who have to "go short" in the ordinary acceptance of that term, due regard being had to their status in life and so forth".

As already stated, a trust or gift can be regarded as charitable under this heading notwithstanding that the object is for the benefit of a definable class. (In *Re Coulthurst* for the benefit of widows and orphans of deceased officers of a bank most deserving of assistance by reason of their financial circumstances, in *Re Wall, Pomeroy v. Willway,*[4] gifts to the poor limited to members of a particular church.)

B. Advancement of education

It has been held that "education" is to have a wide meaning and is not limited to formal instruction.

The fact that a school may charge fees and be primarily for the reasonably well off does not prevent its support and maintenance from being a charitable purpose, provided it is not run for the purpose of making a profit.[5] The following have been held to be included in the term "advancement of education":

(1) "the promotion of encouragement of those arts and graces of life which are, perhaps, the first and best part of the human character";[6]
(2) the promotion of annual chess tournaments for boys;[7]
(3) encouragement of choral singing in London.[8]

On the other hand, a trust for the advancement of education in political matters in the interests of one political party was held not to be charitable.[9] The distinction between this and the cases above seems to have been that although the purpose fell within the meaning of "education" and a "public benefit", the limitation of the purpose to a particular political party was so strong as to become the primary object of the trust.

C. Advancement of religion

Unlike in most of the other areas covered in this article, English precedents are not necessarily valid in Ireland under this heading.

D. Other purposes beneficial to the community

To quote Viscount Cave, L.C. in *A-G v. National Provincial Bank of England:*[10] "It is not enough to say that the trust in question is for public purposes beneficial to the community or for the public welfare; you must also show it to be a charitable trust".

Thus, in *IRC v. Temperance Council of the Christian Churches of England and Wales,*[11] a Council constituted for the purposes of "united action to secure legislative and other temperance reform" was held to have been instituted with the primary purpose of affecting changes in the law and therefore not for a charitable purpose, notwithstanding that the promotion of temperance might be regarded as for the benefit of the community.

V. TAX IMPLICATIONS FOR CHARITABLE DONATIONS AND PHILANTHROPIC SOCIETIES

A. Capital acquisitions tax

Since the Finance Act 1987 (Sec. 50 amending Sec. 54 of the Capital Acquisitions Tax Act 1976), a gift or inheritance taken for "public or charitable purposes" (not defined) is exempt from tax "to the extent that the (Revenue) Commissioners are satisfied that it has been, or will be, applied to purposes which, in accordance with the law of the State, are public or charitable". Prior to this, the Revenue Commissioners would have had to be satisfied that the gift or inheritance had been or would be applied to public or charitable purposes in the State (Republic of Ireland) or Northern Ireland.

The test now is that the "purpose" should be charitable under Irish law. If the "purpose" is not charitable then the benefit received will be treated as a gift or inheritance taken by a donee from an unrelated disponer (Class C) for which the exempt threshold is £ 10,000.00 (subject to aggregation of any other gifts or inheritances taken by the donee from any disponer since 2 June 1982 which will have the effect of reducing the tax-free threshold).

Benefits received by the beneficiary of a charity, specifically including the application of public funds such as moneys provided by the Oireachtas or a local authority, are exempt.

B. Capital gains tax

In general, the disposal of an asset by way of gift or for consideration not greater than cost to a charity will

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3. (1951) All ER 774.
4. 43 Chancery Division 510.
5. *Campbell College v. Commissioners of Valuation Northern Ireland,* (1964) Northern Ireland (NI) 107.
6. *Shaw's Will Trust,* (1952) 1 All ER 49, the will trust of the wife of the famous Irish author George Bernard Shaw.
7. *Re Dupree's Deed Trusts,* (1944) 2 All ER 443.
8. *Royal Choral Society v. IRC,* (1943) 1 All ER 101.
9. *Bonar Law Memorial Trust v. IRC,* (1933) 17 *Tax Cases* (TC) 508.
10. (1924) AC 267.
11. (1926) 10 TC 748.

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be deemed to be for a consideration which would ensure that neither a chargeable gain nor an allowable loss accrued on the disposal.

Under Sec. 22 of the Capital Gains Tax Act 1975, there is a general provision that a gain should not be a chargeable gain if it accrued to a charity and is applicable to, and applied for, charitable purposes. Consequently, if the trustees subsequently dispose of the asset, that disposal would be exempt if the proceeds are applied to charitable purposes.

If, on the other hand, the asset ceases to be subject to charitable trusts (i.e. the charitable purpose ceases or the trustees dispose of the asset and apply the proceeds to a non-charitable purpose), then a capital gains tax liability arises on:
(1) the gain arising to the trustees on the disposal, and
(2) the gain which would have arisen if arm's length provisions had applied to the original disposal to the trustees.

Both gains are assessed on the trustees.

If, for any reason, the asset ceases to be subject to charitable trusts, it will be deemed to have been sold for market value on the date on which it ceased to be so subject, and any gain arising as a result of the deemed sale will be chargeable to capital gains tax.

For the practitioner, it is worth noting that for the charitable donations to be exempt the charity must be absolutely entitled. Thus, in *Prest v. Bettinson,*[12] 5 institutions (4 of which were charities) were entitled to equal shares in the residue of a deceased's estate after payment of certain annuities. The testatrix had left the residue on trust for sale and capital gains arose on the exercise of such trust. It was held that as the residuary beneficiaries were not absolutely entitled as against the trustees (by virtue of the requirement to pay annuities out of the residue), the gain accrued to the "executor trustees" and not to the charities. This is clearly a point to be considered by the practitioner drafting the will of a philanthropic client.

Case law also assists in relation to a donation from one charity to another charity. In *Helen Slater Charitable Trusts Limited,*[13] 2 companies, "the trust" and "the foundation", operated together, both exclusively for charitable purposes – the trust raising funds for the foundation. In 2 specific income tax years, the trust donated almost its entire income to the foundation, much of which the foundation did not distribute but added to its general funds. The Revenue Commissioners contended that the income was not exempt on the grounds that these funds had not been "applied" for charitable purposes.

It was held that such a transfer of money by a charitable corporation, acting intra vires, to any other company established exclusively for charitable purposes was an "application" for charitable purposes even though the transferee merely added the money to its general reserves for future expenditure. This was on the basis that the transferor knew the money would be applied in due course for charitable purposes or at least that it had no reason for thinking that the money would not be so used. This case also confirmed that if trustees of a charity receive income and reinvest it as a part of the funds of the charity, then such will be an "application" for charitable purposes. Conversely, if they leave surplus income uninvested this will not have been "applied". This begs the question how long the trustees of a charity could leave income uninvested.

C. Income tax

Any corporate body, trust or persons established for charitable purposes is a "person" for purposes of individual income tax or corporate tax on all sources of income unless specifically exempted by any provisions in the tax acts. The point of this is that because an entity has "charitable status" does not mean that some of its income will not be liable (e.g. trading income in certain circumstances and income which is not applied to charitable purposes will only be liable).

Sec. 333(1) of the Income Tax Act 1967 gives a general exemption from tax on income provided:
(1) that income forms part of the income of a body of persons or trust established for charitable purposes only; or
(2) that income is, establishing the entity applicable to and applied to charitable purposes only, according to the rules, charter, etc.

Where Irish tax has been deducted at source on such exempted income, it is refundable to the charitable body. In addition, any Irish resident charity would be entitled to reclaim the full U.K. tax credits under Art. 11(3) of the Ireland–U.K. double taxation agreement, including the 15% U.K. income tax withheld on production of a certificate from the Irish Revenue Commissioners confirming that it is exempted from Irish tax as a charity. Practitioners in other jurisdictions would need to check the relevant double taxation agreements with Ireland to confirm that similar provisions exist.

It is important to emphasize that the above exemption is dependent upon the particular income being applied to charitable purposes only. Apart from the test of "application", the only practical problem relates to trading income of a charity.

Under Sec. 334 of the Income Tax Act 1967, a charity that conducts a farming trade and whose profits are applied solely to the purposes of the charity will be exempt from income tax (Sec. 11 of the Finance Act 1981, effective retrospectively from 6 April 1974, being the date on which farming profits became taxable). However, in relation to other trades the exemption is granted if:
(a) the profits are applied solely to the purposes of the charity and
(b) either
  (1) the trade is exercised in the course of the actual

12. (1980) *Simon's Tax Cases* (STC) 607.
13. (1980) STC 150.

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carrying out of a primary purpose of the charity, or
(2) the work in connection with the trade is mainly carried out by beneficiaries of the charity.

If any charity cannot satisfy either part of condition "b", it will be taxable on the profits of the trade but will be entitled to claim any capital allowances, etc.

The academic problem arises where it is agreed that the charity or body of persons is "established for charitable purposes only" and that all the profits are "applied solely to its charitable purposes" but is still taxable on the profits of the trade because the trade is not regarded as in the course of the "primary purpose" of the charity (condition "b1") and the charity cannot satisfy condition "b2".

The principle of "primary purpose" was introduced in Ireland in the Finance Act 1955 which corresponds to the amendment in the U.K. in 1927 in this regard.

Regarding condition "b2", an example would be a convent of nuns where the main work was to carry on a girls' school but which convent was also established for "the sanctification of its members by worship and by labour for the benefit of their fellow creatures".[14]

A specific exemption under Sec. 334(1)(a) Income Tax Act 1967 extends to cover profits or gains arising out of land, tenements or heriditaments which are owned and occupied by the charity for the purposes of mining, quarrying, etc. There is no further condition imposed other than that the charity must be a body of persons or a trust established for charitable purposes only.

In order for a charity to qualify for the test of being "established for charitable purposes only", the primary purpose must be charitable and this is not invalidated by virtue of any ancillary objects incidental or subsidiary to the attainment of that primary purpose even though such ancillary objects might be non-charitable.

The Revenue will look to the main statute or charter or memorandum of an association, etc. to determine what are the objects of the charitable body. If such a document includes any primary object which is not "charitable", the Revenue should decline to grant the charitable status and reject any claim for the repayment of tax. In particular, a tax exemption is not given where there is any chance, however remote, that income or profit could be applied under the object of the charity for purposes other than those of the charity.

Consideration was given to "ancillary purposes" in the case of *Incorporated Council of Law reporting for England and Wales v. AG*[15] where it was held that the Council was established for charitable purposes only, those purposes being either the advancement of education or other charitable purposes beneficial to the community. To quote Buckley L.J.: "the fact that the Council's publications can be regarded as a necessary part of a practising lawyer's equipment does not, in my judgement, at all prevent the Council from being established exclusively for charitable purposes.... It also helps the lawyer to earn his livelihood, but that is incidental to or consequential on the primary scholastic function of advancing and disseminating knowledge of the law...."

The term "application" of income also requires consideration. The normal operating expenses of the charity (including proper remuneration for the employees) has always been accepted as an "application for the charitable purposes" of the charity as is any application for the benefit of the primary objects of such charity.

The position regarding investment of income or transfer of income to another charitable body was considered in the case of *IRC v. Helen Slater Charitable Trusts Limited.*[16]

D. Corporation tax

A reduced corporation tax rate applies (presently 35%) for companies which are established for the advancement of religion or education and which are precluded from distributing their profits to members. This is the only preferential tax treatment given to companies established for charitable purposes, except the general corporation tax exemption (including the income tax and capital gains tax exemptions referred to above).

VI. SUMMARY

Capital donations from an individual or corporate body to authorised charitable organisations for clearly charitable purposes may be unlimited in value. However, the individual will receive no direct incentive by way of a capital tax advantage or allowance from such donation. A corporation may be able to deduct the expenditure if it is deemed wholly and exclusively restricted for the purposes of trade – not any easy case to make. Successive legislators have seen no reason to change this system.

Similarly, charitable contributions are not allowable or deductible expenses against the individual taxpayer's taxable income, except where the contributions are made:
(a) to an Irish university or college for the promotion of research;
(b) to an Irish university, college, school or trust to assist teaching of the natural sciences; or
(c) to a consultative body of the UNO or the Council of Europe, which has as its sole or main objective the promotion of the provisions of the Universal Declaration of Human Rights and/or the implementation of the European Convention of the Protection of Human Rights and Fundamental Freedoms. Moreover, the income must be payable for a period which exceeds 3 years. This is normally the method of a covenant to pay annual income.

14. *Brighton Convent of the Blessed Sacrament v. IRC,* (1933) 18 TC 76.
15. (1971) 3 All ER 1029.
16. See note 13.

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The effect on such covenanted income is that the donor's taxable income is reduced by the annual (grossed-up at standard rate tax) amount covenanted while the beneficiary receives the (net) amount covenanted, including the grossed-up figure in its tax return. In addition, the beneficiary is entitled to reclaim the standard rate tax notionally or actually deducted by the individual.

In common with other jurisdictions, therefore, the tax exemptions relating to charitable giving are "neutral" rather than "positive" in terms of incentive. This reflects a certain ambivalence in successive legislators, partly because of the substantial contribution by the State into social welfare and the reality that individuals and corporate bodies will continue to give in some manner to charitable purposes for a number of reasons not requiring further (tax) incentive.

International Tax Aspects of Philanthropic and Other Non-profit Organisations

German Report

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I. CHARITABLE AND PHILANTHROPIC ORGANISATIONS

A. General

The tax treatment and status of an organisation pursuing philanthropic aims depend on factors that, generally speaking, are related to:
- the purposes pursued by the organisation ("tax privileged purposes") i.e. the use of its assets;
- the funding of the organisation;
- certain "formal" requirements.

These factors are more specifically defined in Sec. 51 et seq. Tax Code ("tax privileged purposes"). It should be noted that the German Tax Code is not a compilation of all German tax laws. Rather, it embodies procedural rules and defines certain general terms (e.g. residence, permanent establishment, etc.). All other issues related to specific taxes are governed by specific statutes (Income Tax Act, Corporate Tax Act, Inheritance Tax Act, etc.). Thus, the Tax Code only defines the preconditions to be met by an organisation in order to qualify as an organisation pursuing tax privileged purposes, whereas the question of which privileges or exemptions are granted to such organisations is governed by the Income Tax Act, Corporate Tax Act, Inheritance Tax Act, etc.

B. Requirements related to the aims pursued by a philanthropic organisation

The Tax Code defines the following 3 types of purposes that, if they are pursued exclusively and directly by an organisation, constitute tax privileged purposes: public benefit purposes, charitable purposes and the support of churches.[1] Even though the term "non-profit organisation" is not a legal term used in the Tax Code, it will be used in this article as a matter of convenience with respect to organisations pursuing tax privileged purposes.

(1) Only corporate entities qualify as non-profit organisations

Tax privileges or exemptions are only available for non-profit organisations that are corporate entities. Individuals or groups of individuals (partnerships) are ineligible. There are, however, no restrictions as to the type of corporation. Therefore, every kind of corporation (foundation, registered association, limited liability company, etc.) is possible.

Organisations that are not taxable in Germany or that are only subject to limited German taxation (e.g. a

1. Sec. 51 Tax Code.

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British organisation maintaining a permanent establishment in Germany) cannot qualify as a non-profit organisation.[2] Tax treaties, of course, may provide for a recognition of foreign non-profit organisations (for further details see infra III).

(2) Public benefit purposes

An organisation pursues public benefit purposes if its activities are devoted to furthering the public materially, spiritually or morally. These purposes must be pursued altruistically. (See infra I.B(5).)

The Tax Code lists some of the more important activities that are recognized as public benefit activities. This list includes such activities as the furtherance of science and research, education, art and culture, religion, child welfare, welfare of the elderly, public health, sports, etc.[3]

An organisation does not pursue public benefit purposes if the group of beneficiaries is firmly limited.[4] This precondition is relatively vague, but it indicates that an organisation does not pursue public purposes if the group of potential beneficiaries is very limited; for example: foundations (trusts) for the support of the members of a family, exclusive sports clubs with a limited number of members and organisations established for the benefit of the personnel of a specific company, etc.

As the list of public purposes in Sec. 52(2) Tax Code is not exclusive, many other activities have been recognized as public purpose activities. In order to determine whether a given activity can be considered a public purpose activity, German tax courts have developed certain basic rules. For instance, a given activity does not necessarily have to be approved by the majority of the population in order to qualify as a public benefit activity.[5] Yet, as the determination whether a given activity is for the public benefit or not is a value judgement rather than a decision based on a well defined concept, fiscal authorities and tax courts will usually base their decision not to recognize a non-profit organisation on one or several of the other preconditions that must be met (see infra).

(3) Charitable purposes

The term "charitable purposes" means that the organisation must dedicate itself altruistically to helping persons in need. Sec. 53 Tax Code distinguishes between two groups of beneficiaries:
(a) persons who need the help of others because of their physical, mental or emotional condition and
(b) persons who need support because of their economic situation.

The latter alternative is limited to persons who have an income of less than four times of the general public welfare rate and who cannot reasonably be expected to improve their income by using property of their own. This limit does not apply to persons who are in need of economic support because of extraordinary circumstances (catastrophes, illness, etc.).

In contrast to the definition of "public benefit purpose", charitable activities must not necessarily be directed to furthering the general public welfare. Yet, as charitable activities are always serving public interests indirectly, this aspect is of no practical importance.

(4) Support of churches

The third group of non-profit organisations consists of organisations supporting churches.[6] This provision only deals with the support of those churches that have the status of a "public law entity". Only a few major Christian churches with long standing traditions have such a status. The Tax Code thus distinguishes between the support of those established churches and the support of other religions or churches. The latter activities can only be tax privileged as public benefit activities pursuant to Sec. 52 Tax Code (supra I.B(2).

(5) Altruism

Non-profit activities will only be tax privileged if they are pursued altruistically. Sec. 55 Tax Code provides a negative definition of the term "altruism" by stating that a non-profit organisation must not pursue economic aims and by establishing certain other (negative) requirements related to the use of its funds.

(a) *Commercial purposes*

The organisation must not "primarily" be operated for its own economic benefit or for the benefit of its members, shareholders, officers, etc. This requirement corresponds to the positive definition of "public benefit purposes" and raises the following problems:
– organisations established by several enterprises belonging to the same business branch to pursue aims that are common to all members of such business branch have in many instances been considered primarily in pursuit of the commercial interest of their members. Example: Association established by horse breeders to organize fairs, shows, etc.;
– there is much doubt whether and to what extent a non-profit organisation is allowed to derive profit from its activities (not considering a related business and income derived from donations considered infra). For instance, if an organisation provides public benefit services at rates that are intentionally calculated high enough to produce profits, such intention may not effect the altruistic nature of the services if the organisation needs such profits to compensate prior losses.[7] Without such a justification, however, profits that are more than marginal will usually indicate that the activities are pursued for the economic benefit of the organisation and not altruistically.

2. Sec. 5(2) No. 3 Corporate Tax Act; Sec. 3(2) Capital Tax Act; Federal Tax Court, *Federal Tax Gazette* 75, 595.
3. Sec. 52(2) Tax Code.
4. Id.
5. Federal Tax High Court, *Federal Tax Gazette* II 72, 440 (mediation approved as a public benefit purpose).
6. Sec. 54 Tax Code.
7. Federal Tax High Court, *Federal Tax Gazette* II 77, 250.

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(b) *Additional specific requirements*

(i) The organisation may use its funds for its statutory purposes only. No part of the income of the organisation can be payable or otherwise made available to any of its members or shareholders. Furthermore, the organisation may not use its funds directly or indirectly for political parties.

A foundation may use, as an exception to these requirements, up to 25% of its income to adequately support the founder (grantor) and his close relatives.[8] The duty to use funds only for the purposes set forth in the statutes of the organisation implies a duty not to build up assets. Thus, a non-profit organisation must spend its funds within a reasonable period of time for its statutory purposes; it may not simply save them unless such savings are necessary to achieve the aims of the non-profit organisation.

General intention to spend the reserves of the non-profit organisation at one point of time is not enough. Rather, reserves, if any, must be formed for a specified project.[9] Yet, as a non-profit organisation, like any commercial enterprise, cannot be operated continuously and safely without reserves, the German legislator introduced a further exception in 1985 by providing that a non-profit organisation may use up to 25% of its profits to build up a general (contingency) reserve.[10] It should also be noted that the restrictions against accumulating reserves do not apply to grants to a foundation and to testamentary donations.

(ii) Altruism furthermore requires that the members of the non-profit organisation do not receive back more than they contributed originally in the event that their membership ceases or the organisation is dissolved.

(iii) Moreover, the non-profit organisation must not grant anyone benefits by generating expenses that are not related to the purpose of the organisation or that are unreasonably high.[11]

(iv) In case the non-profit organisation is dissolved or in case its original purposes cannot be further pursued, its assets may only be used for tax privileged purposes. This precondition, among others, is met if the assets are turned over to another non-profit organisation or to a public law entity for tax privileged purposes.

(6) Exclusiveness

The activities of a non-profit organisation must be limited to pursuing its tax privileged statutory purposes only. Several tax privileged purposes (for instance, charitable and religious purposes) may be combined, but it is not possible to combine tax privileged purposes with other purposes.

With respect to funding of a non-profit organisation, the Tax Code permits the operation of a related business (see C infra).

(7) Direct support of tax privileged purposes

A non-profit organisation is generally obligated to pursue its tax privileged purposes directly, not through third parties; of course, the non-profit organisation may employ personnel to pursue its aims. Furthermore, the Tax Code[12] permits the following exceptions:

- a non-profit organisation may limit itself to collecting funds to support tax privileged purposes pursued by another organisation or by a public law entity;
- a non-profit organisation may donate part of its funds to another non-profit organisation (or public law entity) pursuing the same tax privileged purposes;
- a non-profit organisation may provide personnel to other institutions (not necessarily non-profit organisations) to pursue non-profit purposes;
- a non-profit organisation may provide space to another non-profit organisation to support the non-profit aims of such other organisation.

C. Funding

(1) General

As outlined above, the general status of an institution as a non-profit organisation depends primarily on the purposes it pursues (public benefit purposes, charitable purposes, support of churches) and on how such purposes are pursued (altruistically, exclusively and directly). If these preconditions are not met, the organisation as a whole will not qualify as a non-profit organisation. By contrast, the preconditions related to funding a non-profit organisation do not affect, in principle, the status as a whole. Rather, these preconditions are related to the question of the extent to which a non-profit organisation is eligible for certain tax privileges. For instance, the operation of an unrelated business by a non-profit organisation will not necessarily affect the non-profit status of the organisation, but the non-profit organisation will not enjoy any tax privileges for income derived from that unrelated business.

Apart from income derived from donations, a non-profit organisation may derive income from the administration of its assets, the operation of a related business and the operation of unrelated business. The tax treatment of its income depends on the source from which it is derived.

(2) Administration of assets

To the extent that the non-profit organisation derives income from the administration of its assets, it will be eligible for all tax benefits that are generally available for non-profit organisations. The Tax Code does not define the term "administration of assets". Sec. 14 sentence 3, merely states that, as a rule, the use of

8. Sec. 58 No. 5 Tax Code.
9. Federal Tax High Court, *Federal Tax Gazette* II 79, 496.
10. Sec. 58 No. 7(a) Tax Code.
11. Sec. 55(1) No. 3 Tax Code.
12. Sec. 58 Nos. 1-4.

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assets (e.g. the investment of capital or letting out (leasing) immovable property) is an administration of assets rather than a business activity. Thus, the main factor to determine whether a given activity is to be characterized as an administration of assets or as a business activity is whether profits (or income) are primarily derived from using an asset or from an activity as such (which may or may not involve the use of assets). The question of which one of these aspects is dominating and characteristic for a given activity is, of course, a value judgement. For instance, depositing money in a savings account obviously does not constitute a business activity. If, however, a non-profit organisation invests its assets in a sophisticated way, involving frequent transfers of stock, bonds, real estate, etc., such investment activities may constitute a business activity.

(3) Unrelated business

Pursuant to Sec. 14 Tax Code, an unrelated business ("commercial business") is constituted by an independent and constant activity producing income or other economical advantages and exceeding the limits of a (private) administration of assets. As the non-profit activities of a non-profit organisation are also pursued independently and permanently, this definition of a business activity is not much more than a vague guideline.

The distinctions made by the fiscal authorities on the basis of this vague definition are value judgements and usually based on precedents. Examples of business activities are: operation of a cafeteria by a sports club; sale of sportswear by a sports club; sale of postcards, calendars, records, etc. by a non-profit organisation; merchandising agreements between sports clubs and manufacturers of sports equipment, etc.

(4) Related business

While a non-profit organisation is not entitled to any tax privileges with respect to income derived from a business operation, income from a business that is related to the purposes of the non-profit organisation is generally tax-exempt or privileged. Sec. 65 Tax Code establishes the following 3 preconditions for a related business:

- the business must be operated in order to support the non-profit, statutory purposes of the organisation;
- the operation of the business must be necessary in order to achieve the non-profit purposes;
- there must be no avoidable competition between the business and the business of other, non-privileged businesses of the same or similar kind.

The examples for related businesses are numerous. Some of the more important examples, expressly listed in Sec. 68 Tax Code, include old age homes, workshops for handicapped persons, cultural institutions such as museums, theatres, exhibitions, etc.

D. Formal requirements – Review by fiscal authorities

(1) "Formal" requirements

In addition to the factors outlined so far, the non-profit status of an organisation depends on its compliance with certain formal requirements and certain requirements related to its actual management. All of these are related to the statutes (articles of incorporation) of the organisation.

(a) *Statutes (articles of incorporation)*

An organisation is only eligible for tax privileges if its statutes clearly define the purposes of the organisation. Such description must be specific enough to determine whether the activities are non-profit activities. It is not sufficient to merely cite the language used in the Tax Code (e.g. by merely providing that the organisation pursues "charitable purposes"). The statutes, furthermore, must state that such a purpose will be pursued exclusively and directly. Further, there must be a clause governing the use of the assets of the organisation in case it is dissolved or if the achievement of its aims has become impossible.

(b) *Actual management*

In addition to the general requirement that a non-profit organisation must be managed in accordance with the general preconditions outlined above, the actual management must furthermore comply with the above mentioned (supra (a)) clauses of the statutes of the organisation. For instance, a charitable organisation must not pursue charitable purposes other than those defined in its statutes.

The tax consequences of a violation of these requirements differ depending on the tax at issue. For instance, the organisation will lose its tax privileges under the Corporate Tax Act and the Trade Tax Act for the entire assessment period if the statutes do not meet the above formal requirement or if the actual management does not comply with the statutes at any time during such assessment period. By contrast, if the non-profit organisation received a donation before it violated the above requirements, the tax exemption for such donation will not be affected unless the organisation used the donation for non-privileged purposes.

(c) *Adequate records*

A non-profit organisation must keep adequate records on its income and expenses to prove that its actual management complies with its statutes.

(2) Registration

There are no formal recognition or registration procedures for non-profit organisations. Thus, the question whether an organisation is considered a non-profit organisation is part of the assessment procedure for each type of tax. Theoretically, the non-profit status of an organisation could thus be recognized for one

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type of tax (e.g. corporate tax) while not recognized for another type of tax (e.g. gift tax). Yet, in practice, the organisation's characterization for corporate tax purposes is usually the basis for all other taxes.

When a new non-profit organisation is formed, its statutes (articles of incorporation) are usually reviewed by the competent tax office. If the statutes meet the above formal requirements, the tax office will issue a preliminary certificate stating that the organisation is a non-profit organisation. This certificate, however, does not bind the tax office in any way and does not constitute a precondition for the tax status of a non-profit organisation.

From time to time (usually every 3 years), the tax office reviews the activities of a non-profit organisation informally, normally by requesting that a questionnaire is completed and that the business records are submitted. If, on the basis of this documentation the tax office is satisfied that the non- profit organisation complies with all preconditions, it may (and usually will) issue a notice of exemption to confirm the non-profit status of the organisation. Furthermore, the tax office may issue a certificate to confirm that the organisation is eligible for tax privileged donations.

II. TAX TREATMENT OF NON-PROFIT ORGANISATIONS

A. Gift and inheritance tax

The tax treatment of inter vivos gifts and of the devolution of an estate is governed by one statute in the Federal Republic of Germany: the Inheritance and Gift Tax Act ("Inheritance Act"). Thus, in this article the term "inheritance tax" will include gift taxes and the term "donation" or "gift" will include inter vivos gifts and testamentary bequests.

Pursuant to the Inheritance Act, gifts to domestic churches (public law entities), domestic Jewish Communities and to domestic non-profit organisations are exempt from inheritance tax. The tax exemption is, however, revocable retroactively if the preconditions for the non-profit status of the recipient organisation cease to exist within 10 years after the gift was made, unless the donation was actually used for non-profit purposes.[13]

Donations by individuals to non-profit organisations are generally tax-deductible for income tax purposes.[14] Subject to certain exceptions (in particular with respect to political parties), the maximum annual deduction is generally 5% of the total annual income of the donor and 2% of the total turnover and the total salaries paid by the donor during the year. Donations to public purpose organisations are only tax-deductible if the purposes pursued by the organisation are recognized as particularly worth furthering (the income tax regulations contain a long list of such activities).

The same rules are applicable with respect to donations by corporations pursuant to Sec. 9 No. 3 Corporate Tax Act.

A second alternative to effect tax-free donations for non-profit purposes is established by Sec. 13(1) No. 17 Gift Tax Act. Pursuant to this provision, donations made exclusively for public benefit purposes, charitable purposes or to churches are exempt from gift tax if the use of the donation for such purposes is secured. The donation may either be made directly for the non-profit purpose or it may be made indirectly, i.e. to a third party under the condition that the donation is used for a certain non-profit purpose. This second alternative is usually available if the donation is used immediately for non-profit purposes. The tax office will usually consider such use as secured if the taxpayer is able to show that the donation has actually been used for non-profit purposes.

B. Corporate tax, trade tax

Non-profit organisations are exempt from corporate taxes.[15] This exemption does not apply to income derived form an unrelated business operated by the non-profit organisation. The same applies with respect to trade tax.[16]

C. Real estate tax, capital tax

Non-profit organisations are exempt from these taxes unless the property is used for the operation of an unrelated business.[17]

D. Turnover tax (VAT)

Certain charitable, medical and cultural services rendered by non-profit organisations are exempt from turnover tax.[18] Further, the turnover tax rate for services rendered by non-profit organisations (with the exception of an unrelated business) is reduced to 7%[19] (the regular rate is 14% in Germany).

E. Other exemptions

Transactions with respect to domestic non-profit organisations (e.g. the assignment of shares in such organisations) are exempt from capital transfer tax.[20] Lotteries organized for non-profit purposes are exempt from lottery tax if the total price of the lots does not exceed 75,000 DM.[21]

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13. Sec. 13(1) No. 16(b) Gift Tax Act.
14. Sec. 10(d) Income Tax Act.
15. Sec. 5(1) No. 9 Corporate Tax Act.
16. Sec. 3 No. 6, 20(b)(c) Trade Tax Act.
17. Secs. 3 (I) Nos. 3, 4 and 4 No. 6 Real Property Tax Act; Sec. 3 (I) Nos. 4, 12 Capital Tax Act.
18. Sec. 4 Nos. 16, 18, 22, 25 Turnover Tax Act.
19. Sec. 3(2) No. 8 Turnover Tax Act.
20. Sec. 7(1) No. 1 Capital Transfer Act.
21. Sec. 18 No. 2 Lottery Tax Act.

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III. INTERNATIONAL TAX ASPECTS OF NON-PROFIT ORGANISATIONS

A. International activities of domestic non-profit organisations

A non-profit organisation may pursue its purposes in or outside of the Federal Republic of Germany. For instance, a charitable foundation may pursue the sole purpose of providing medical aid in developing countries, etc. Thus, there are no geographical restrictions on the activities of a non-profit organisation.

B. Recognition of foreign non-profit organisations

(1) Donations to foreign non-profit organisations

Only donations to domestic non-profit organisations are exempt from inheritance tax.[22] Thus, donations to foreign non-profit organisations are generally not exempt from German inheritance tax.[23] Unless there is a tax treaty between the Federal Republic of Germany and the country of the recipient non-profit organisation, the only way to effect a tax-free gift to a foreign non-profit organisation is to make a donation for specific purposes.[24] Example: a German donor provides the funds for constructing a hospital for the poor in India.

The Federal Republic of Germany is presently bound by 5 tax treaties dealing with inheritance taxes. The treaties between the Federal Republic of Germany and Greece, Austria, Sweden and Switzerland, however, are not applicable to inter vivos gifts. Like the OECD Draft of 1966, these treaties do not contain any express language concerning the tax treatment of non-profit organisations. The only tax treaty that is broader in both respects is the Convention between the Federal Republic of Germany and the United States for the Avoidance of Double Taxation with respect to estates, inheritance and gifts. As to the mutual recognition of non-profit organisations, Art. 10(2) provides as follows:

> Property transferred to or for the use of a corporation or organisation of a Contracting State organized and operated exclusively for religious, charitable, scientific, educational or public purposes, or to a body of a Contracting State to be used for such purposes, shall be exempt from tax by the other Contracting State, if and to the extent that such corporation, organisation, or public body (a) is exempt from tax in the first mentioned Contracting State, and (b) would be exempt from tax in the other Contracting State if it were made to a similar corporation, organisation or public body of that other State. The competent authorities of the Contracting States shall by mutual agreement settle the application of this provision.

As the Convention came into force only in 1986, it cannot yet be said how this provision will be applied. The first and most obvious issue is whether the application of Art. 10(2) governs donations to any "non-profit organisation" or only donations to non-profit organisations that pursue "religious, charitable, scientific, educational, or public purposes". As outlined above (supra I.B(2), (3) and (4), the German Tax Code establishes 3 types of non-profit organisations, depending on the purposes pursued by such organisations (public benefit purposes, charitable purposes, support of churches). The language used in Art. 10(2) is different from the terminology used in the German Tax Code. In particular, the term "public benefit purpose", which covers most non-profit activities (amongst others religious, scientific and educational activities) is not used in Art. 10(2) of the Convention. The question is thus whether Art. 10(2) was supposed to exclude the mutual recognition of those public benefit purposes that are not expressly referred to (i.e. religious, scientific and educational purposes) or whether the term "public purposes", which is used in Art. 10(2) but not in the Tax Code, was supposed to serve as a fall-back clause. As there is no reason why such recognized "public purpose activities" as sports, cultural activities, etc. should not be governed by Art. 10(2), it would appear that the term "public purposes" should be given a broad meaning to the effect that it covers all activities pursued for the benefit of the general public.

Another important issue concerns the language "similar corporation etc." in Art. 10(2)(b) of the Convention. It remains to be seen what degree of similarity will be required by the U.S. and German tax authorities. Art. 10(2) provides that the competent authorities of the Contracting States shall by mutual agreement settle the application. Yet, I do not expect an agreement for some time as the competent German authorities, at present, are only preparing negotiations with the American authorities.

In addition to the above tax treaties, the Federal Republic of Germany has also exchanged formal declarations with the Netherlands, Denmark and some of the Swiss cantons according to which donations (by testament and inter vivos) to organisations pursuing public benefit purposes, charitable purposes or supporting churches are exempt from gift and inheritance taxes.[25]

Apart from the question of whether donations by German donors to foreign non-profit organisations are exempt from German inheritance and gift tax, the second issue in this context is whether such donations are deductible for German income and corporate tax purposes (see supra II) This issue is expressly covered by a circulation letter of the Federal Ministry of Finance of 2/2/1987 (DStR 1987, 237). According to such letter, the representatives of the highest fiscal authorities have determined that donations to a foreign foundation are not deductible for income tax purposes because the "provisions of the Tax Code do not apply to foreign foundations and because domestic

22. Sec. 13(1) No. 16 Inheritance Tax Act.
23. Federal Tax High Court, *Federal Tax Gazette* 84 II, 9.
24. Sec. 13(1) No. 17 Gift Tax Act.
25. Ministry of Finance of Northrhine-Westfalia (15 June 1964) *Betrieb* 935; Ministry of Finance of Hessen (10 August 1960) DVR 63, 16; Ministry of Finance of Northrhine-Westfalia (12 November 1975) *Betrieb* 76, 269.

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tax offices cannot, for legal and factual reasons, examine (review) the activities of foreign foundations. Further, it would not be possible to impose sanctions in case it should turn out, subsequently, that the assets which were donated have not been used properly". As there is no tax treaty specifically dealing with this question (Art. 10(2) of the U.S.–Federal Republic of Germany tax treaty on inheritance taxes only deals with inheritance taxes), it would seem that there are no exceptions to the rule that donations to foreign non-profit organisations are non-deductible.

(2) Tax treatment of foreign non-profit organisations

If a foreign non-profit organisation pursues activities attracting German income or corporate tax, i.e. if the organisation has the status of a non-resident taxpayer (limited taxability pursuant to Sec. 49 Income Tax Act), its non-profit status is generally disregarded because only domestic organisations can be recognized as non-profit organisations pursuant to Sec. 51 Tax Code (supra I.A and I.B). Most tax treaties signed by the Federal Republic of Germany contain non-discrimination clauses that are identical with or similar to Art. 24 of the OECD Draft treaty. Yet, the taxation of foreign non-profit organisations is not considered to violate such non-discrimination clauses.

Example: A British non-profit organisation derives income from German real estate. Such income will be taxable in Germany without regard to the non-profit status under British tax laws.[26]

The following are the only 2 exceptions to this rule:
- foreign cultural associations (theatre, music, dance, etc.) are exempt from German income tax if their performance in the Federal Republic of Germany is subsidized substantially from domestic or foreign public (government) funds.[27]
- the convention between the Federal Republic of Germany and the United States for the Avoidance of Double Taxation with Respect to Taxes on Income and to certain other taxes provides for a mutual recognition of non-profit organisations in Art. XV A:

(1) A German company or organization operated exclusively for religious, charitable, scientific, educational or public purposes shall be exempt from tax by the United States, if and to the extent that:

(a) such company or organisation is exempt form tax in the Federal Republic, and
(b) such company or organisation would be exempt from tax in the United States if it was organized, and carried on all its activities in the United States.

(2) A United States corporation or organization operated exclusively for religious, charitable, scientific, educational or public purposes shall be exempt from tax by the Federal Republic, if and to the extent that:
(a) such a corporation or organisation is exempt from tax in the United States, and
(b) such corporation or organisation would be exempt from tax in the Federal Republic if it was a German company or organisation and carried on all its activities in the Federal Republic.

The term "public purposes" is generally considered to cover all non-profit purposes that are recognized in the United States or the Federal Republic of Germany. Further, by contrast to Art. 10(2) of the Gift Tax Treaty with the United States, Art. 15A of the Income Tax Treaty does not use the word "similar". Yet, when examining whether a U.S. organisation meets the German requirements related to the status of a non-profit organisation, such examination is primarily focused on the purposes pursued by the organisation. As to the additional requirements (exclusive, direct and altruistic pursuance of non-profit purposes, etc.), German tax offices frequently confine themselves to a formal test, i.e. they examine the articles of incorporation of the U.S. non-profit corporation and ask for a verification of the tax-exempt status by the U.S. Revenue Service. Based on this documentation, U.S. non-profit organisations are usually recognized in the Federal Republic if they pursue purposes that are recognized as non-profit purposes under the Tax Code.

IV. OTHER NON-PROFIT ORGANISATIONS

A. Pension funds, funeral societies and health insurers Sec. 5(1) No. 3 Corporate Tax Act

These organisations are exempt from corporate tax if the following conditions are satisfied:
- their beneficiaries are members or former members of one or several business enterprises, or members of certain charitable institutions (e.g. the German Red Cross) or of other corporations that are liable to pay corporate tax;
- it is certain that the assets and income of the organisation are exclusively and directly used for the purposes set forth in its statutes;
- the total assets of the organisation do not exceed certain limits.

The organisation must be organized as a corporation. Further, the tax exemption does not apply to non-resident organisations.[28] Organisations of this type are also exempt from capital (wealth) tax[29], and donations to such organisations are exempt from inheritance tax.[30]

B. Small mutual insurance companies

Small mutual insurance associations are exempt from corporate tax if their income derived from contributions does not exceed certain limits established by government regulation, if their business is limited to granting death benefits and if, on the basis of their business plan and the nature and amount of their pay-

26. Federal Tax High Court, *Federal Tax Gazette* 77 II, 178.
27. Letter by Federal Ministry of Finance (20 July 1983), *Federal Tax Gazette* 83 I, 382.
28. Sec. 5(2) No. 3 Corporate Tax Act.
29. Sec. 3 No. 5 Capital Tax Act.
30. Sec. 13 No. 13 Inheritance Tax Act.

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ments, they are "social institutions.[31] Organisations of this type are also exempt from capital (wealth) tax[32], but not from inheritance tax.

C. Professional (functional) organisations

Associations established by the members of a given profession that do have a public law status are exempt from corporate tax if they are pursuing non-commercial purposes.[33] They are furthermore exempt from capital (wealth) tax,[34] but not from gift tax.

D. Political parties

Political parties are exempt from corporate tax.[35] Further, donations to political parties are exempt from inheritance tax.[36] Political parties are also exempt from capital (wealth) tax.[37]

Donations to political parties are deductible for income (and corporate) tax purposes only within the limits of Sec. 10(b) Income Tax Act (starting 1989, the maximum deduction is 60,000 DM per year). Donations exceeding 40,000 DM per year must be reported in the parties' annual report.

E. Pensions funds organized under public law

These institutions are exempt from corporate tax if the membership is mandatory and if the contributions paid by members do not exceed certain limits established by statute.[38] Organisations of this type are also exempt from capital (wealth) tax.[39]

F. Non-profit home building companies, cooperatives and associations[40]

This tax exemption is only available for home building companies that are providing and administrating small homes (apartments) at low cost and that are therefore recognized as non-profit home builders by the administrative authorities (not the tax offices) of the lands. In the light of numerous scandals involving the biggest German non-profit housing corporation, which was owned by the German Trade Union Federation, there has been much discussion as to whether there are still valid reasons to grant tax exemptions of this kind. Starting 1990, the exemption will be limited to cooperations and associations providing homes to their members.The above non-profit corporations are exempt from capital (wealth) tax.[41]

G. Government owned or recognized low cost housing institutions[42]

These exemptions pertain to low cost housing institutions (including credit institutions, etc.) that are government owned (instruments of the government housing policy) or recognized by the competent authorities or non-profit housing institutions. These entities are also exempt from wealth tax.[43]

H. Agricultural cooperative associations[44]

This exemption applies to cooperatives formed by agricultural producers to pursue common aims. Such aims are limited to the following:
– the common use of operating equipment;
– services for the production of agricultural products by the members;
– the processing or use of the agricultural products of the members;
– advice related to the production and processing of agricultural products of the members.

If, generally speaking, these limits are exceeded, the cooperative loses all tax benefits.

I. Mutual pension insurance associations[45]

This exemption concerns insurance associations covering the risk of an insolvency of private pension funds.

J. Insurances established by credit institutions[46]

This exemption concerns private insurances established by banks and other credit institutions with the aim to assist the creditors of a member bank in case it should fail to perform its obligations.

As repeatedly emphasized before, the above exemptions are only granted to domestic organisations. As to the international tax treatment of these specific non-profit organisations listed here, there are no particularities, i.e. the general principles outlined above under III apply without any specific modifications.

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31. Sec. 5(1) No. 4 Corporate Tax Act.
32. Sec. 5(1) Nos. 5, 6 Corporate Tax Act.
33. Sec. 3 No. 6 Capital Tax Act.
34. Sec. 3 Nos. 8, 9 Capital Tax Act.
35. Sec. 5(1) No. 7 Corporate Tax Act.
36. Sec. 13(1) No. 18 Inheritance Tax Act.
37. Sec. 3 No. 10 Capital Tax Act.
38. Sec. 5(1) No. 8 Corporate Tax Act.
39. Sec. 3 No. 11 Capital Tax Act.
40. Sec. 5(1) No. 10 Corporate Tax Act.
41. Sec. 3 No. 13 Capital Tax Act.
42. Sec. 5(1) No. 12 Corporate Tax Act.
43. Sec. 3(I) No. 15. Capital Tax Act.
44. Sec. 5(1) No. 14 Corporate Tax Act.
45. Sec. 5(1) No. 15 Corporate Tax Act.
46. Sec. 5(1) No. 16 Corporate Tax Act.

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International Tax Aspects of Charitable Giving and Philanthropic Organisations

French Aspects

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I. PURPOSE AND SCOPE

The purpose of this article is to examine the French tax aspects of charitable and philanthropic organisations in the international context. Unlike Anglo-Saxon tax laws, French tax law contains only a few measures specifically applying to charitable or philanthropic organisations, although some recent provisions have been enacted in this respect (e.g. law dated 23 July 1987 encouraging gifts to non-profit associations – Art. 7 of the Finance Act for 1989).

II. PERSONS INVOLVED IN A CHARITABLE AND PHILANTHROPIC GIFT

A. Donor

Gifts made by all individuals or legal entities to charitable and philanthropic organisations benefit from tax incentives.

B. Non-profit organisations collecting and obtaining gifts from charitable or philanthropic organisations

Organisations which may receive tax-deductible gifts are listed below.

(1) Assistance and charitable organisations

The charitable aspect of the organisation is determined under objective criteria: conditions of activity and organisation of the activity performed, regardless of the organisation's legal form.

(2) General interest organisations

Organisations are characterised as general interest when:

- the activity is non-profitable;
- management does not take into account any profitability when managing the organisation;
- no advantage is granted to members of the organisation.

According to courts, the realization of auxiliary paying acts does not disqualify the general interest characterization of an organisation when the 5 following conditions are met:

- the performed activity is strictly within the framework of the non-profitable activity of the organisation;
- the organisation cannot grant any direct or indirect profit to its founders or members;
- excess receipts must not be a goal of the organisation;
- when excess receipts exist, they must be reinvested within the organisation;
- the organisation must have a social utility.

The activity of the organisation must benefit anybody and not be limited to a special category of persons. Moreover, the organisation must perform its activity in France. However, gifts made to French organisations whose purpose is to collect gifts and to organize charitable programs for the benefit of people of undeveloped foreign countries are tax-deductible within the limits described below. In addition, for organisations developing the preservation of the French national artistic heritage, the spread of the French language, culture and scientific knowledge, deductibility is possible if they perform at least a part of their activity in France.

(3) Religious organisations

Gifts are deductible when those organisations have a philanthropic or charitable activity.

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(4) Associations or foundations officially acknowledged to serve the public

Their purpose constitutes general interest, but they must first obtain approval from the French administration.

C. Recipients

Recipients or end users of the charitable process may be individuals, communities, states, and certain associations having a social, environmental or charitable purpose. Recipients of the gifts must correspond to the category of beneficiaries listed in the articles of the philanthropic or charitable organisation. However, the social purpose of the association or foundation does not qualify, by itself, for the preferential tax treatment. It is necessary to take into account the actual activity of the organisation.[1] Recipients may be either French or foreign individuals or legal entities.

III. TAX TREATMENT OF GIFTS

A. At the donor's level

(1) General rules

Gifts made for the benefit of general interest organisations are deductible for tax purposes. Conditions and limits of those deductions vary with regard to the type of donor (individuals or legal entities) and beneficiary. Only pure gifts are deductible (i.e. without any direct or indirect counterpart).

Gifts can be made in cash or in kind. Cash gifts can theoretically be deducted for the entire amount made. Conversely, in kind gifts can only be deducted up to the amount of either the book value of the asset given, the book value of the inventory given or the cost price of the service rendered. Gifts of art works, however, are deductible on the basis of the acquisition price or the value determined by the tax administration.

(2) Gifts made by enterprises

In principle, gifts are only deductible when they are made in direct connection with the enterprise's interest. However, companies are authorized to deduct gifts to general interest organisations up to a maximum of 0.3% of their annual turnover (all taxes included).[2] In order to claim such a deduction, the general company's tax results must be profitable. This total limit includes all gifts made to general interest organisations and associations or foundations officially acknowledged to serve public purposes as well as gifts of art works to the State.

Enterprises subject to individual income tax can elect to deduct contributions up to 0.3% of their annual turnover from income or to offset the value of gifts up to 1.25% or 5% (depending on the type of beneficiary organisation) of the final individual income tax due. A deduction is allowed for contributions to non-profit associations, philanthropic, educational, scientific, cultural, social or family associations within certain percentage ceilings based on turnover. This deduction also applies to gifts made to associations encouraging sports, the preservation of the French national artistic heritage, the environment and the spread of French language, culture and scientific knowledge.

In general, the deduction for charitable contributions is limited to 0.2% of the donor enterprise's annual turnover. This limit is raised to 0.3% for gifts to officially recognized cultural or humanitarian associations or foundations. This 0.3% limit also applies for contributions to public institutions of higher learning or to officially approved public or private research organisations.

If the allowable limits are exceeded during one financial year, the excess may be carried forward to the following 5 years provided that the excess can only be carried forward when the annual contributions of the year have been offset and the deductible limit cannot be exceeded. Even when there is a loss during one financial year, the possibility of a carry-forward still exists.

(3) Gifts made by individuals

French individual taxpayers can only deduct their contributions to non-recognized associations and charities to the extent that they do not exceed 1.25% of their net taxable income. On the other hand, contributions made to recognized charities and non-profit associations can be deducted up to 5% of the net taxable income. In order to qualify for this special deduction regime, the charity or association must be recognized by the French authorities. Among those organisations are "Fondation de France", French Red Cross, "Secours Catholique", International Federation of Human Rights, etc.

This 5% limit also applies to certain religious associations or charities which have been authorized by the tax administration to receive gifts. It should be noted that the French tax administration does not allow deductions when the beneficiary charitable organisation does not perform its activity in France. However, it is not mandatory that the head office of the charitable organisation be located in France. Deduction of contributions is only allowed if the contributions are allocated to promote actions of general interest realised in France or from France. Therefore, gifts made to foreign organisations or to organisations performing their entire activity abroad are not deductible for French tax purposes.

It is possible, however, to deduct gifts made to French associations or organisations whose purpose is charitable or philanthropic activities in foreign countries (e.g. Third World countries). The tax benefit that could be claimed as a result of the 1.25% or 5% deduction cannot be less than 25% of amounts deducted for the

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1. Ministerial Answer to Chovat, M.P., (30)(1) Official Gazette 484 (1989).
2. French Tax Code Sec. 238 bis AA.

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annual part of gifts that does not exceed 1,200 Ffrs. As a result, the first 1,200 Ffrs. contributed will accord the taxpayer a 300 Ffrs. tax reduction. For taxation of 1989 income, the rate of the tax credit is raised to the highest marginal tax rate (56.8%) when the taxpayer can substantiate gifts of at least 1,200 Ffrs.

In order to claim a deduction, it is compulsory to attach supporting documents to the annual tax return (i.e. an official receipt from the relevant association evidencing the gift). Those documents are provided by the charitable organisation.

Following the 1989 Finance Act, contributions allocated to the supply of free meals to needy people give rise to tax benefits. The Act gives taxpayers 2 options. Under the first option, taxpayers may elect to take a tax credit equal to 50% of the gift but limited to 400 Ffrs.; the excess is deductible up to 1.25% or 5% of the taxable income, depending on the type of recipient association or foundation. Under the second option, taxpayers may deduct the contributions from income to a maximum 1.25% or 5% of taxable income. As for 1989 income, this regime applies both to the supply of food in France and abroad.

B. Tax treatment of charities

(1) Corporate income tax

Non-profit associations and therefore charitable organisations are normally not subject to corporate income tax when they act within the scope of their activity (i.e. non-profit activity). However, they can be subject to corporate income tax at the full 42% rate on their income from profit-making activities only when such earnings are not exempt by law or administrative regulations. The effect of those exemptions is usually to allow some tax-free, commercial-like activities when the activities are an extension of the non-profit purpose of the associations.

A special tax regime applies to income deriving from the non-profit organisations' assets (e.g. rent of buildings owned by the organisations, dividends received, etc.). For this type of income, the corporate income tax rate is 24%. A 10% rate applies on interest received by non-profit associations. When corporate income tax amounts to less than 1,000 Ffrs., it is not payable. Foundations officially acknowledged to serve public purposes benefit from a 100,000 Ffrs. abatement on corporate income tax due with regard to assets owned.

(2) Value added tax (VAT)

Non-profit charitable, cultural, educational, religious, political or sports associations are normally not under the scope of VAT. They can, nevertheless, be subject to VAT when their activities are within the scope of VAT (commercial activities).

However, commercial operations made for the benefit of members or third parties by non-profit organisations whose purpose is social or philanthropic activities (e.g. charities) and whose management is not for profit are exempt from VAT provided that:

- prices made have been approved by the French administration;
- similar operations are not currently made by business entities at comparable prices.

Furthermore, there is no VAT applying on receipts of 6 annual charity meetings (concerts, shows, charity sale actions, etc.) when those meetings are held by charities for their own benefit. This exemption applies to entrance tickets to those meetings and to the receipts received in respect to food, brewery, advertisement, rent of showrooms and stands, charity sales, grants or subsidies.

Another condition for exemption from VAT is that management act without self-interest, i.e.:

- management and administration must be conducted, without remuneration, by persons having no financial interest in the operating results;
- no distribution of profits by the organisation to its managers or members;
- no sharing of the organisation's assets for the benefit of members of the organisation.

In addition, charitable or philanthropic organisations may acquire or import, free of VAT, goods that will be exported for the needs of their charitable or philanthropic activity. Gifts made by companies to charitable and philanthropic organisations for the realization of humanitarian, charitable or philanthropic acts abroad are out of the scope of VAT, providing that the organisations which will distribute such gifts abroad can file a certificate indicating the reason for the gifts and the place where the gifts will be distributed.

(3) Wages tax

Entities not subject to VAT are, nevertheless, subject to wages tax based on the amounts of salaries paid. For 1989 salary payments, the rate of this tax is 4.25% on the first 33,660 Ffrs. of annual salary, 8.5% on the amount between 33,660 Ffrs. and 67,310 Ffrs. and 13.60% on the amount over 67,310 Ffrs.

(4) Business licence tax

Charitable and philanthropic organisations are not subject to business licence tax providing they act within the framework of their activity (i.e. non-profit activity).

(5) Transfer tax

Gifts made to charities and philanthropic organisations are exempt from gift tax (60%) on condition that such gifts are directly allocated to the charitable or philanthropic purpose of the organisation.

IV. INTERNATIONAL ASPECTS

A. Tax deductibility of gifts

In order to be tax-deductible, gifts must be made to charities or foundations performing their activity in France. However, it is not necessary that those charities or foundations have their head office in

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France. Deduction of gifts is only possible when those gifts are allocated to the promotion of general interest activities realized in France or from France. As a consequence, gifts made to foreign charities or foundations performing all of their activity abroad are not tax-deductible.

As a matter of fact, should a French individual or legal entity make a contribution to an international foreign charity or foundation, this contribution will not be tax-deductible for income tax purpose unless the charity or foundation performs at least part of its charitable activity in France. However, gifts made to French charities or foundations performing their charitable activity abroad are tax-deductible.

B. Gift duties

Under domestic law, and subject to provisions of an applicable tax treaty, when the donor is domiciled in France, all movable or immovable property is taxable regardless of its type or location. Gifts made to organisations acknowledged to serve public purposes (authorized charitable or philanthropic organisations) are exempt from gift duties when an official administrative regulation has stated that such organisations were authorised to receive gifts. This regime only applies to French organisations.

The gift tax rate applying to gifts made to third parties (i.e. charities or philanthropic organisations that have not been approved to receive tax-free gifts) is 60%. This rate is applied to the fair market value of the gift. Conversely, when gifts are made to foreign charities or foundations, they are normally subject to gift tax. However, such taxation does not apply to charities or foundations of a foreign country which have signed a reciprocity agreement with France. France has signed such agreements with Israel, Italy, Switzerland, Sweden, Belgium and the United States.

C. Investment income of charities from foreign source

Subject to contrary provisions of an applicable tax treaty, investment income derived from foreign sources and received by French charities or foundations will be subject to normal taxation rules. Providing they qualify as non-profit organisations, a 24% tax rate will apply to rental income or on dividends received. Interest received will be subject to a 10% rate.

Should a foreign charity receive any income from a French source and providing a tax treaty exists, it can only claim the benefit of the tax treaty if it is subject to income tax in its own country. If not, it will not be considered as domiciled in France for treaty purposes, and therefore will not benefit from favourable provisions of the tax treaty (e.g. reduction of withholding tax on dividends or interest income).

D. Contributions made by foreign donors

Providing the charity or foundation qualifies for tax-exempt status in France, contributions made by French or foreign donors (i.e. residents or non-residents) will not be treated as taxable income in France. Individuals who are not domiciled in France for tax purposes can, however, be subject to individual income tax on a part of their income (French-source income). They are not entitled to deduct from individual income tax payable in France gifts made to French or foreign charities.[3]

V. TAX TREATY ISSUES

A. Income tax treaties

Unlike various treaties signed by Anglo-Saxon countries, tax treaties signed by France do not include any provisions relating to charities or foundations. The only provision concerning charities derives from an administrative regulation relating to the application of the U.S.–French tax treaty.[4]

Under this regulation, it is indicated that, as no reciprocity agreement exists between France and the United States, contributions made to U.S. charities by French residents are not deductible for income tax purposes in France, regardless of the donor's nationality, since no specific provision exists in the French–U.S. tax treaty. Charities or foundations will only be able to benefit from tax treaties signed by France if they are subject to income tax within their country of domicile.

B. Succession and gift tax treaties

France has signed various reciprocity agreements with foreign countries relating to gift taxes (the United States, Switzerland, Belgium, Sweden, Italy and Israel). According to those agreements, the exemption of gift tax applying under domestic law to French charities or foundations is also applicable to gifts made to charities or foundations situated in these countries. In addition, certain specific agreements signed with the Federal Republic of Germany, Austria and Hungary also grant a gift tax exemption for several listed organisations.

3. French Tax Code Sec. 164 (A); Ministerial Answer to Habert, M.P., 868 (28 July 1988).
4. Administrative Regulation 14(B)(2), No. 7 (25 March 1981).

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National and International Tax Aspects of Charities and Charitable Contributions

Swiss Report

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I. INTRODUCTION

A. Overview of the tax system in Switzerland

Taxes in Switzerland are basically levied at 3 distinct levels: federal, cantonal and community.

1. Federal taxes

Federal taxes include the following:
(a) the federal income tax;
(b) the federal net wealth/capital tax (levied only on entities such as companies, etc.);
(c) the federal stamp duties (one of the taxes levied in connection with the issue and the transfer of some securities, investment fund certificates and negotiable instruments, the appreciation of capital stock of limited companies, and the payment of certain insurance premiums);
(d) the turnover tax (levied on the transfer of goods by wholesalers and on the importation of various goods);
(e) withholding taxes (35% levied at source on certain income derived from Swiss bonds and similar long-term investments, profit distributions by resident companies and Swiss resident bank deposits. The tax is exclusively levied on Swiss-source income and might be subject to a full or partial refund by virtue of Swiss domestic tax provisions or income tax treaty provisions).

2. Cantonal taxes

Cantonal taxes, i.e. taxes levied on the level of the 26 Swiss cantons consist in most cantons of:
(a) the cantonal income tax;
(b) the cantonal net wealth/capital tax;
(c) the cantonal inheritance and gift taxes.

In deciding which taxes to impose, the cantons have been given substantial discretion. On the basis of Art. 46(2) of the Swiss Constitution which provides for the enactment of provisions against intercantonal double taxation, a considerable body of case law relating to the avoidance of such intercantonal double taxation has developed, thereby defining more precisely the limits of the cantonal tax autonomy. However, as a matter of fact, these provisions have not yet been implemented.

Although there are considerable differences between the tax systems of the cantons, the following main parameters are common to all cantons:
- all cantons levy income and net wealth/capital taxes, but the determination of the relevant tax basis (e.g. of the net income, personal allowances, tax brackets, etc.), however, differs considerably;
- most cantons do not tax capital gains of individuals;
- all cantons except the canton of Schwyz levy cantonal inheritance taxes. The same is true with respect to gift taxes except in the cantons of Schwyz and Lucerne.

3. Community taxes

Communities are also entitled to levy additional income and net wealth/capital taxes. In most cantons those taxes are regulated by cantonal laws. Accordingly, the communities are allowed to determine the actual tax brackets by applying a coefficient on the basis of the cantonal rates. As a note, the main burden of direct taxes (approx. 2/3) is borne by cantonal and community taxes and not by federal taxes.

For purposes of this article, however, there will be no particular emphasis on community taxes. Further, capital gains and turnover taxes both on the cantonal and community level do not play an important role within the framework of this article. If appropriate, however, reference will be made. It should also be mentioned that certain cantons allow recognised churches to levy taxes from their members; the assessment of such taxes is often administered by the cantons.

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B. The notion of "charitable purpose" – elements of a definition

Art. 16(3) of the governing Federal Tax Law Act (Bundesratsbeschluss über die Erhebung einer direkten Bundessteuer) provides for tax exemption of "the assets and the income of entities and establishments which are used for religious or educational purposes, for the benefit of the poor and of the ill, aged and/or handicapped people or for other exclusively charitable purpose". Whereas the definition of the "religious and educational" purpose and the support of "ill, aged and/or handicapped people" does not cause major difficulties in most instances, a precise definition of the 'umbrella' term of "exclusive charitable purpose" will often cause more problems.

The term "exclusive charitable purpose" as contained in the Federal Tax Law Act requires on the one hand that the activity of the particular entity or establishment be in the interests of the Swiss community (public benefit purpose) and on the other hand that there be the element of sacrifice either by third parties or by the members of the entity or establishment. Thus, the contributions should be made altruistically (Swiss Supreme Court Decision of 19 October 1950 in: ASA (Archiv für Schweizerisches Abgaberecht), Vol. 19, p. 328 ss.).

The interests of the Swiss community are normally defined along the lines of the official government activities which means that the scope of governmental undertakings in the field of aid to and support of third parties is relevant. For example, the objective of granting scientific, social and cultural aid to East-European countries, in particular to one specific country, and, in addition, to grant 100 of the value of the above aid to Third World countries, has only hesitantly been accepted by the federal authorities as qualifying for tax exemption. As a statutory purpose, it has been considered as (possibly) being too specific; the actual activities have therefore been subjected to regular reviews.

Most definitions in the cantonal tax laws mention "charitable purposes" ("gemeinnützige Zwecke") without giving further elements of a comprehensive definition. Additional terms used are those of "religious purposes", "altruistic purposes" and of "beneficial purposes" ("wohltätige Zwecke"). See for instance the income tax laws of Berne (Art. 23(9) and Art. 34 lit. k)[1], Geneva (Art. 21 lit. u, Art. 75, Art. 111, Art. 122), Lucerne (Art. 12(5)), Vaud (Art. 15 lit. f, Art. 23 lit. n, Art. 55 lit. d), and Zurich (Art. 16 lit. d, Art. 25 lit. m, Art. 46 lit. e). Additional references can be found in the various cantonal inheritance and gift tax laws.

Although a concrete and precise definition of "charitable purpose" has not been provided, the following tests are used as a guide in determining which activities are charitable.

(a) The term "charitable purpose" basically excludes profit-oriented activities and purposes aiming at the self-help of the founders, members and supporters of the recipient organisation. Profit-oriented activities encompass all economic activities at arm's length prices with a view to generating profits. Profit-oriented activities, however, do not necessarily prevent tax-exempt status. The operation of a business may be permitted if the profits generated therefrom are used to accomplish the charitable purpose of the recipient organisation. Moreover, a charitable organisation may derive income from the administration of its assets.

Self-help activities may be described as activities which are not intended to benefit third persons but rather to support personal interests. An example of this could be an association aiming at the promotion of economic interests of its members. Self-help activities, however, which aim at the promotion of idealistic interests, may lead to a tax exemption.

(b) A "charitable purpose" must consist of activities aiming at the promotion of public benefit purposes, i.e. there must basically be an unlimited number of potential beneficiaries (see, however, para. (d) below). The term "promotion of the public good" includes all activities which could also be performed by state authorities (on the community, cantonal or federal level). The granting of state subsidies to a specific organisation might therefore be an indication favouring tax-exempt status.

(c) A further element consists in the notion of sacrifice. There can be no charitable purpose without making a financial sacrifice or contributing personal work without adequate consideration.

(d) Moreover, the "charitable purpose" must basically aim to provide benefits to the general public and not to the donors, founders or supporters of the organisation. Certain statutory or factual limitations of the charitable activities, however, are admissible. For instance, it has been recognised that a charitable association may limit its activities to a certain geographical area or community without losing its tax-exempt status. The charity may also impose restrictions on its beneficiaries, such as adherence to a certain religious belief.

(e) Merely a statutory charitable purpose is not sufficient; the actual charitable activities must be continuing and present. Furthermore, the "charitable purpose" must be of a lasting nature. An adequate use of the charity's assets upon its dissolution or in case the achievement of its aims has become impossible must be provided for by the articles of association which mostly means a transfer of such assets to another organisation pursuing similar tax-exempt purposes in the given situation.

The above standards may vary considerably from can-

1. See, however, Art. 5 of the Governmental Decree of 1 December 1964 (Berne) regarding tax-exempt status of certain organisations, which defines a charitable contribution as being made "for the benefit of the general public and in an altruistic way, meaning that the personal interests of the persons involved have to be totally excluded for the benefit of the third parties".

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ton to canton because a recognised and unified definition does not exist.

C. Charitable institutions

Neither the legal form of an organisation nor its type of funding (e.g. by state subsidies or by private gifts) are decisive in determining what constitutes a "charitable institution" for tax-exempt purposes. The following elements, however, are required.

First, the recipient organisation must be a legal entity in order to qualify for tax-exempt status. Organisations are classified as either public or private. The former is primarily governed by federal or cantonal administrative laws while the latter is governed by private/civil law (i.e. Civil Code (CC) and Code of Obligations (CO)). The following will focus almost entirely private organisations[2]. The respective rules include the law of legal entities, associations and foundations as set forth in the CC, the law of partnership and companies as set forth in the CO and contractual arrangements similarly contained in the CO. Except for tax law purposes, there is no basic distinction between the applicable rules for profit and non-profit making organisations. Most structures may be used both for profit and non-profit making, and commercial and non-commercial activities.

Secondly, non-profit organisations must pursue cultural, welfare, religious or charitable purposes. If all requirements relating to their purposes and to their purposes and to their actual management are met, it will be tax-exempt. On the other hand, non-profit making organisations with other purposes (e.g. business associations or labour unions) are, in principle, subject to taxation in the same way as commercial enterprises.

Finally, board members of charitable organisations (e.g. a foundation) may be compensated for their services performed but not to the extent of members of commercial profit making entities. Otherwise, tax-exempt status may not be granted, or it may be revoked. This is the interpretation of the Federal Tax Act by competent authorities, according to a recent unpublished ruling.

The above overview, however, should not conceal the fact that different tax rules exist depending on the precise legal form in which organisations are established. Corporations, associations and partnerships for instance are subject to different tax rules. Furthermore, it must be stated that a fair number of non-profit making organisations are per se tax-exempt, such as the state, cantons, communities, certain churches, social security institutions, some pension funds, etc. as long as they are pursuing activities which are within their recognised scope of objectives.

2. Art. 16(3) of the Federal Tax Act for instance makes reference only to private organisations.
3. Most cantonal rules are less liberal in that respect. See Sec. II(C)(1) below.
4. See also Sec. VI below.

II. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

A. Federal level

On the federal level, charitable gifts donated by individuals do not normally qualify for a reduction in taxable income. If such individuals, however, are required by statute to keep books of accounts of their commercial activities, then they qualify for deduction of charitable gifts from their net income (Art. 22 lit. f of the Federal Tax Law Act). Similarly, legal entities such as corporations and cooperations do qualify for deduction of charitable gifts (Art. 49(2) of the Federal Tax Law Act).

Charitable contributions are deductible for purposes of the federal tax if the recipient organisation is tax-exempt, irrespective of whether it and donor are domiciled in the same canton or if the contributions are used exclusively for the charitable purpose. Charitable contributions to foreign recipients seem to be generally tax-exempt if they are exclusively used for a charitable purpose abroad which is recognised by the Swiss Federal Tax Administration.[3] No previous approval by the tax administration is required, however.[4] Moreover, on the federal level, there is no limitation on the deductible amount of charitable contributions.

B. Cantonal level

On the cantonal level, both individuals and organisations are normally allowed to deduct charitable gifts for income tax purposes. The most fundamental requirements for deductibility are the tax-exempt status of the recipient organisation and that the contribution be used exclusively for a charitable purpose. There are, however, quite considerable differences between the cantonal tax laws (see also Sec. III below).

In most cantons, individuals may deduct charitable gifts for income tax purposes (no deductions seem to be allowed in the cantons of Graubunden, Lucerne, Nidwalden, Ticino and Uri; administrative practice, however, seems to allow it at least partially). With respect to legal entities, the majority of the cantons provide for a deduction (no deductions are formally allowed in the cantons of Graubunden, Lucerne and Ticino; administrative practice, however, seems to allow them).

C. Restrictions on the federal and cantonal levels

(1) Geographical restrictions

In many cantons, there are various geographical restrictions to be observed. These restrictions are illustrated by the examples below.

(a) *Donor and recipient in canton A, activity of the recipient organisation exclusively in canton B or abroad*

As mentioned above, on the federal level any particular charitable contribution seems to be tax-exempt if

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the charitable organisation abroad is operating within the scope of the Swiss public interest (public benefit purpose), such as the granting of humanitarian aid, the support of environmental protection, development aid, etc. The requirements are more stringent if the activity is "solely" culturally oriented; the charitable organisation will then most likely be required to deploy a share of its activity in Switzerland.

The cantonal solutions vary considerably: Where some cantons require the charitable organisation to operate exclusively within its territory or at least in its interest (e.g. Appenzell A.Rh.), most cantons follow a less parochial approach. As a result, it is sufficient that the purpose and the operations of the charitable organisation be in the interest of the general Swiss public (public benefit purpose).

(b) *Donor in canton "A", recipient in canton "B', activity in cantons "B" or "C"*

The basic rule is that such contributions are not deductible unless there are reciprocity agreements between the cantons. The following examples may give an impression of the complexity of the existing reciprocity agreements forming a remarkable network all over Switzerland.

Zurich presently has, on the basis of Art. 18 lit. a of its Tax Law Act, reciprocity agreements with 21 cantons, including Berne, Zug, Schaffhausen, St. Gallen, Aargau and Vaud. Tax-exempt status may be granted with respect to cantons where no formal reciprocity exists if the activities of the specific organisation are in the general interest of Switzerland (such as development aid to Third World countries).

Berne presently has reciprocity agreements with Basle-Town, Basle Country, Lucerne, St.Gallen, Vaud, Zurich, Jura, Appenzell A. Rh, Schwyz, etc. Upon application, tax-exempt status may be granted with respect to cantons where no such agreements exist. Vaud presently has reciprocity agreements with Berne, Zurich, St. Gallen, Glarus, Aargau, Basle-Town, Lucerne, Zug, Graubunden, Thurgau, Appenzell A.Rh., Neuchatel, Basle Country, Geneva and Valais. On the basis of administrative practice, reciprocity seems to be granted vis-à-vis Fribourg.

(c) *Donor in canton "A", foreign recipient*

In general reciprocity is required. Various cantons do have related agreements with foreign countries as to the equal treatment of their organisations on the territory of the contracting state with the latter's religious or charitable organisations. Those agreements do normally encompass both inter vivos gifts and donations made on the basis of testaments. The following list[5] gives a rough impression of the network of such reciprocity agreements without going into the details of each agreement:

	Germany	France	Israel	Liechtenstein	U.S.A.
Aargau		x			
Appenzell A. Rh.	x	x			
Appenzell I. Rh.	x	x			
Basle Country		x			
Basle-Town	x	x	x		x
Berne		x			
Fribourg		x		x	
Geneva		x			
Glarus		x			
Graubunden	x	x		x	
Jura		x			
Lucerne		x			
Neuchâtel		x			
Nidwalden	x				
Obwalden		x			
St. Gallen	x	x		x	
Schaffhausen		x		x	
Solothurn	x	x			
Tessin		x			
Thurgau	x	x			
Uri	x	x			
Vaud	x	x			
Zug	x	x			
Zurich		x			x

The above examples reflect the basic ingredients of the Swiss tax law system which provides for considerable autonomy of the cantons. The underlying philosophy of most cantonal tax laws is rather locally (cantonally) oriented than nationally or transnationally.

(2) Restrictions as to the deductible amounts

Only a minority of the cantonal tax laws (i.e. 4 of 26) provide for the unlimited deduction of charitable gifts for income tax purposes of individuals (the ratio being 12 of 26 in the case of legal entities); they are Appenzell I.Rh., Basle-Town, Neuchatel and Vaud. Other cantons provide for maximum deductions between 5% and 20% of the taxable income. Yet, others provide for minimum amounts, normally between 50 Sfrs. and 500 Sfrs., of gifts to be deducted.

The following chart illustrates the maximum cantonal deductions for charitable contributions by individuals [for legal entities there is no limitation in the majority of the cantons, except[6] in the cantons of Appenzell A. Rh. (20%), Berne (5%), Fribourg (5%/15%), Jura (5%), Nidwalden (10%), Obwalden (5%, max. of 10,000 Sfrs.), Schaffhausen (10%), Schwyz (10%), Solothurn (10%), Valais (10%), Zurich (20%). No deductions are formally allowed in the cantons of Graubunden, Lucerne and Ticino for legal entities; administrative practice, however, seems to allow them]. The chart, however, does not take into account the differences in the determination of the relevant tax basis (net income, personal allowances, etc.) as provided for in the different cantonal tax laws:

5. Source: *Internationales Steuerrecht der Schweiz,* Collection of Swiss Treaties and Implementing Regulations, issued by the Federal Tax Administration of Switzerland, with the text of the above-mentioned agreements and declarations.

6. The following figures are normally computed on the gross income of the legal entities. Due to the different determination of the relevant tax basis by each canton, however, such figures are hardly comparable.

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Cantons	Maximum deduction	Cantons	Maximum deductions
Zurich	20%	Aargau	20%
Berne	5%(1)	Schwyz	10%
Glarus	5%	Thurgau	10%
Obwalden	(2)	Vaud	(6)
Zug	10%	Valais	10%
Fribourg	5%(3)	Neuchâtel	(6)
Solothurn	8,000 Sfrs.(4)	Geneva	2%/7%
Basle-Town	(5)	Jura	5%
Basle Country	no ceiling	Uri	no deduction(7)
Schaffhausen	20%	Graubunden	no deduction(7)
St. Gallen	10%	Lucerne	no deduction(7)
Appenzell I.Rh.	no ceiling	Nidwalden	no deduction(7)
Appenzell A.Rh.	20%	Ticino	no deduction (7)

(1) May be increased by the canton, a recognised church or an organisation which is substantially supported by a community or the canton.
(2) 5% up to a maximum of 10,000 Sfrs.
(3) May be increased up to a maximum of 15% if the recipient is a community, the canton, a recognised church or an organisation which is substantially by a community or the canton.
(4) Self-employed individuals may deduct up to a maximum of 10% of their gross income.
(5) No limitation for contributions to inner cantonal organisations; limitations for contributions to extra-cantonal institutions to be determined by the cantonal authorities.
(6) To be determined by the cantonal authorities.
(7) Administrative practice seems to allow certain deductions.

(3) Restrictions on use of charitable contributions

In all cases, charitable contributions are to be irrevocable.

With respect to the deductibility of charitable contributions by taxpayers who are domiciled in one canton but who are taxed on some of their income and/or assets in another canton, a proportional deduction of the taxpayers' charitable contributions will be applied in both cantons according to the respective shares of their income/assets. This is one of the applications of Art. 46(2) of the Swiss Constitution providing for the avoidance of double taxation.

All cantonal gift and inheritance tax laws provide for the possibility of tax exemption for charitable contributions (see e.g. Art. 10 lit. e of the Zurich Inheritance and Donation Tax Act, Art. 6 of the Geneva Inheritance and Donation Tax Law Act).

III. TAX TREATMENT OF CHARITABLE ORGANISATIONS

All cantonal tax laws provide for the possibility of tax exemption of charitable organisations with respect to income and net wealth/capital taxes. The same is true with respect to federal taxes including income, net wealth/capital taxes and stamp duties.

Concerning land transfer and capital gains taxes on real property owned by charitable organisations, certain cantonal tax laws provide for tax-exempt status only if the land is directly used for e.g. religious or educational purposes. However, several limitations may apply.

A. Geographical restrictions

Certain cantons provide for tax-exempt status only if the canton benefits directly from the activities of the respective charitable organisation.

B. Restrictions as to the activities of charitable organisations

In most cantons, income (respectively of the assets) which is directly devoted to charitable purposes is exempt from taxation. In such cases, the accounting system must clearly distinguish between income used for charitable purposes and other income, but no separate legal structure is required for the income devoted to charitable activities.

Partial exemption seems to be possible in most cantons where total exemption is not forthcoming. A minority of the cantons, however, require that the entire income (respectively all assets) be used for charitable activities. Furthermore, the charitable activities must be irrevocable, and it must be ensured that the contributions are not used and/or will not be used (e.g. in case of dissolution of the charitable organisation) for other (namely profit-oriented) activities. The fact that certain incidental income is earned (if used as a means of accomplishing the intended charitable purpose) does not necessarily deprive the charitable organisation of its entitlement to tax-exempt status.

IV. TAX TREATMENT OF RECIPIENTS OF FUNDS FROM CHARITABLE ORGANISATIONS

The receipt of a charitable contribution by a beneficiary of the charitable organisation is not treated as income (see for instance Art. 21A lit. d of the Geneva Income Tax Law). Thus, the ultimate recipient will not incur any income tax liability. There might, however, be a problem if the charitable contributions consist of regular payments; such cases could probably lead to a tax liability.

V. INTERNATIONAL ASPECTS

Although most has been discussed in the context of the preceding remarks[7], basically two situations must be distinguished:
(a) charitable contributions given to an organisation having its seat in the same canton or at least in Switzerland but pursuing its charitable purpose abroad and
(b) charitable contributions given directly to foreign charitable organisations.

Under cantonal law, only a few rules as to the treatment of charitable contributions to cantonal or Swiss institutions having an international charitable purpose exist. For instance, Art. 9 of the Lucerne Tax Law Act

7. See Sec. II(C)(1) above.

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provides for tax-exempt status of such institutions if the charitable activities of such institutions are "universally oriented". Zurich allows a tax exemption if the foreign activities of the charitable organisation, having its seat in Zurich, are within "the general Swiss interests". The test in most cantons tends to be whether some benefit for the particular cantons (where the institution has its seat) or at least for the Swiss Community can be derived from the trans-border activities of the charitable organisation. This is certainly a rather fluid test.

Even though Switzerland has concluded numerous bilateral treaties regarding the avoidance of double taxation with respect to taxes on income and capital[8] on the one hand and inheritance taxes[9] on the other hand, no such treaty between Switzerland and another country seems to make any specific reference to charities or charitable gifts. There are, however, declarations of reciprocity as to the exemption of certain charitable institutions (reference is made to the list as contained in Sec. II(C)(1)(c) above), such as the bilateral agreement of 30 October 1979 between Switzerland[10] and France regarding the taxation of charitable contributions[11].

As a very general rule, it can be therefore that foreign charitable institutions do not normally enjoy any recognition in Switzerland. Consequently, charitable gifts to foreign charitable institutions in most cases do not qualify for preferential tax treatment (deductions).

VI. PROCEDURAL ASPECTS

Both with respect to federal and most cantonal taxes, in general, no formal recognition or registration procedure is required[12]. Tax exemption is normally granted when a tax return together with a related application has been filed i.e. as part of the assessment procedure. On the federal level and in most cantons, preliminary, non-binding opinion letters issued by the competent tax authorities may be obtained in order to reduce the uncertainty as to tax-exempt status. The actual management of the charitable organisation will be reviewed regularly by the tax authorities in order to ascertain compliance with its statutory purpose.

VII. CONCLUDING REMARKS

There is a remarkable diversity in both the treatment of charitable contributions and the treatment of charitable institutions within Switzerland. Since one of the essential features of the notion of "charity" is the furtherance of "public benefit purposes", a harmonisation of the different legal systems relating to inter-cantonal charitable contributions may be recommended.

With respect to the international aspects of the topic, the possibility of preferential tax treatment of charitable gifts to foreign charities with a generally recognised purpose should be further examined, be it by means of bilateral recognition or multilateral undertakings.

The above suggestions are made on the basis that charitable donations have an important role to play, both in terms of their actual economic importance and functional approach which seems to indicate that privately directed charitable contributions may lead to a certain privatisation of classic state functions. Tax laws should not hinder but rather support such approach.

8. As per 30 July 1989, treaties regarding the avoidance of double taxation with respect to taxes on income (I) and on capital/wealth (C) were in force with the following countries:
Australia (I), Belgium (I and C), Denmark (I and C), Federal Republic of Germany (I and C), Finland (I and C), France (I and C), Greece (I), United Kingdom (I), Ireland (I and C), Italy (I and C), Japan (I), Canada (I and C), South-Korea (I), Malaysia (I), New Zealand (I); Netherlands (I and C), Norway (I and C), Austria (I and C), Pakistan (I), Portugal (I and C), Sweden (I and C), Singapore (I and C), Soviet Union (I), Spain (I and C), Sri Lank (I and C), South Africa (I), Trinidad and Tobago (I), Hungary (I and C), United States (I).

9. As per 30 July 1989 treaties regarding the avoidance of double taxation on inheritance taxes were in force with the following countries: France, Federal Republic of Germany, Denmark, Finland, Great Britain, Netherlands, Norway, Austria, Sweden, U.S.A.

10. The Swiss government representing various cantons which by virtue of the Swiss constitution are not allowed to directly enter into agreements with foreign states.

11. See the Official Collection of Swiss Laws, SR 0.642.034.91.

12. See, however, as an example of an exemption the registration and approval procedure as outlined in Art. 9B of the Implementing Regulations of 30 December 1958 to the Geneva Tax Law Act (a list of tax-exempt charitable organisations shall be established by the cantonal authorities for each calendar year. The relating application has to be filed by March 31 of the preceding year).

CONFERENCE DIARY

DECEMBER 1989

EC 1992: A Single Market. Implications for Tax Executives and their Companies. Washington, 10-12 December (English):
Tax Executive Institute, Inc., 1001 Pennsylvania Avenue, NW, Suite 320, Washington, D.C. 10004-2505, U.S.A.

Managing and Compensating Expatriates. Brussels, 11-13 December (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL – 3417 ZH Montfoort, The Netherlands.

Tax Efficient Personal Investment Conference. London, 12 December (English):
Tolley Publishing Co. Ltd., Conference Department, FREEPOST, Tolley House, 2 Addiscombe Road, Croydon, Surrey, CR9 9EA, United Kingdom.

JANUARY 1990

API/PSU Tax Course Program – January 1990: Introduction to U.S./International Taxation, 8-10 January; U.S. Taxation of International Joint Ventures, 11-12 January; *or* U.S. Taxation of corporate reorganizations, 11-12 January. Paris area (English):
The American Tax Institute, 9 avenue Matignon, 75008 Paris, France.

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International Tax Aspects of Philanthropic and Other Non-profit Organisations:

Spain

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I. DEFINITIONS

A basic distinction must be established between companies (sociedades) and other entities, such as the (in Spanish legal terminology) "corporaciones", foundations, and associations (corporaciones, asociaciones y fundaciones" in the terms of the Spanish Civil Code).[1]

Entities are classified as either non-profit or profit-making entities. Companies are characterised by their profit motive and the exploitation of an enterprise or undertaking for the benefit of its shareholders.[2] On the contrary, foundations and associations, as non-profit public or private entities, are not established for purposes of providing economic benefits to its members.

Foundations are entities established on a capital basis and act to fulfil a general interest or goal defined in their by-laws.

Moreover, there is no general body of rules that apply to all foundations as a group. The rules vary with respect to the type of foundation. For instance, charity foundations (fundaciones beneficas) are governed by a Decree of 1899 while cultural, private foundations are governed by a Decree of 21 July 1972. Several autonomous regions (Comunidades Autónomas) are competent to govern them. Thus, the "Comunidad Autónoma" of Catalonia issued the 1/1982 Act of 3 March on Private Foundations.

Associations are established on a personal basis, including individuals and other entities (e.g. Association of Golf Clubs), in order to realize the purpose defined by the parties in the association contract and are essentially subject to the Associations Act of 24 December 1964. More particular rules regulate the activity and organisation of political parties, work unions or entities of social provision and insurance.

Finally, "corporaciones" are created by an administrative act. Some are defined as public law entities but are governed by public rules in some aspects of their activity while the rest are subject to private law rules.

II. TAX TREATMENT OF NON-PROFIT ORGANISATIONS UNDER SPANISH LAW

An examination of the Spanish taxation system clearly reveals that there is neither unitary nor systematic treatment of non-profit organisations. Current law never treats them as a whole, but only as an aspect of more general regulations.

In this article, we will not consider the various public authorities competent to administer the different taxes. It should be noted that the process of decentralisation of the public administration in Spain directly affects some aspects of this organisation. The application of certain taxes is controlled by the State and others by the autonomous communities.

A. Corporate tax

1. Exemptions

The rules applicable to non-profit organisations are embodied in the Corporate Tax Act[3] and are further regulated by Royal Decree[4]. Art. 5 of the Corporate Tax Act establishes a general principle of exemptions in favour of the State (Central Administration and regional autonomous administrations) and public institutions. However, limited exemptions are granted in favour of:

(a) entities of social provision (montepíos y entidades de previsión social);
(b) the Spanish Red Cross Organisation;
(c) institutions, foundations and associations deemed by public agreement as charitable or of public utility. Directors or legal representatives of such entities must be non-remunerated and responsible for their activity before the administration of the institution considered. The same exemption is granted to temporary associations or organisations

1. Art. (35)(1).
2. Civil Code, Art. 1665; Commercial Code, Art. 116.
3. (7 December 1978) No. 61.
4. (15 October 1982) No. 2631.

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that, whether with or without juridical personality, are not established to collect funds for a concrete operation or activity;

(d) publicly recognised political parties, professional associations, official Chambers of Commerce and other non-profit organisations.

Special reference must be made at this juncture to the taxation of churches and dependent organisations, which are assimilated to the exempt entities mentioned under (a) to (d). The Organic Act of Religious Liberty[5] officially recognises and grants juridical personality to churches, confessions and religious organisations when they are registered in the corresponding Public Registry at the Ministry of Justice. Art. 30 of the Corporate Tax Act[6] grants a tax exemption to the Roman Catholic Church and other churches with which the Spanish State has signed a cooperation agreement. The cooperation agreement[7] with the Roman Catholic Church establishes, for example, a general exemption for religious activities. Similar exemptions are also granted for transfers and successions and donations taxes.

Based on Art. 30(1) of the Corporate Tax Act,[8] associations that operate primarily for profit and whose directors or trustees are remunerated cannot be considered as non-profit organisations.

2. Non-exempted activities

Despite the previous discussion, all income received by the exempt entities included under (a) to (d) above is not tax-exempt. Non-exempt income includes:

(1) income from economic exploitations;

(2) income from the rental or assignment of capital assets (i.e. leasing);

(3) income from a capital gain;

(4) income withheld at the source according to the rules of the Corporate Tax Act (i.e. income from movable capital, interest, dividends and financial assets).

Income from these sources is considered non-exempt even when obtained by the State and other public institutions.

The Royal Decree[9] provides that only when such income is derived from activities which represent the social goal or motive of the institution concerned, will it benefit from the exemption. The interpretation of this point and its limits are not quite clear, however.

According to the State's Budget Act for 1989, taxable income is subject to a rate of 20% in the case of non-profit organisations. However, the ordinary tax rate for corporations is 35%.

B. Transfers tax (Impuesto Sobre Transmisiones Patrimoniales y Actos Jurídicos Documentados)

Under Act 32[10] and the Royal Decree[11], this tax is levied on transfers by non-profit entities as opposed to profit making entities which are subject to VAT. The tax is specifically levied on real estate transfers at a rate of 6% and movable property at a rate of 4%.

Some exemptions are considered in Art. 59 of the Royal Decree.[12] Among those are exemptions relating to organisations of cultural foundations or social provision (specifically "montepíos de previsión social") and organisations having educational or scientific activities as a purpose. Further, directors and legal representatives are not to be remunerated and are responsible for their activity before the administration. However, organisations of social provision and those who do not remunerate their directors, trustees or legal representatives are exempt from the transfer tax.

Approval of this exemption, in every case, is subject to the discretion of the Spanish Treasury Ministry. An organisation or foundation which benefits from the exemption must be recognised and classified as a "charitable" organisation with independence as its objective or goal. The exemption is granted not only to registered associations, such as foundations and "montepíos" of social provision, but also to organisations classified as a "public utility" dedicated to assisting subnormal individuals and senior citizens. Further, the exemption applies to organisations with a charitable, cultural, scientific or teaching character.

C. Successions and donations tax

The tax rate imposed by the Act[13] severely burdens the profitability of transferring goods to non-exempt organisations, whether "mortis causa" or "inter vivos". For "inter vivos" transfers, the rates vary between 7.65% to 24.99%, depending on the value of the goods transferred. However, goods that are valued at more than 100 million pesetas are subject to a marginal rate of 34%. If, on the other hand, the goods are valued under 100 million pesetas, then the rate will be based on the beneficiary's net worth and his relationship to the donor (the rate will be, for example, multiplied by 2 in the case where there is no family relationship between donor and donee and the net worth of the donee exceeds 50 million pesetas).

As for the exempt organisations, final disposition No. 4 grants the exemption to the same concerned by Art. 5 of the Corporate Tax Act (15). (See (II)(A) above).

D. Value added tax

Value added tax (VAT) was enacted in Spain by Act 30 of 2 August 1985 and developed by Royal Decree 2028 of 30 October 1985. Under the decree, exemptions are granted to so-called "entities with social character", particularly entities of social provision and

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5. (5 July 1980) No. 7.
6. Enacted by Royal Decree 2631/1982 [hereinafter R.D. followed by the applicable number].
7. Dated 3 January 1979.
8. Enacted by R.D. 2631/1982.
9. No. 2631/1982, Art. 349.
10. Dated 21 June 1980, amended text of 30 December 1980.
11. (30 December 1981) No. 3,494.
12. Id.
13. (18 December 1987) No. 29.

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associations and foundations deemed by public agreement as charitable organisations. Essentially, "entities with social character" refers to organisations with a non-profit motive and which restrict their economic benefits to charitable activities and to their directors, legal representatives or associates and direct affiliates. This last requisite is not mandatory for entities conducting social assistance services as defined under (a) infra.

The exempt services conducted by public organisations or by social private institutions are essentially the following:

(a) Social assistance (e.g. youth protection, alcoholics or prevention of delinquency);[14]
(b) assistance for sport activities;[15]
(c) cultural services, museums, libraries, movies, etc.[16];
(d) services offered to their associates by non-profit organisations with an exclusively political, religious, patriotic or philanthropic finality, and which do not obtain from them payments other than ordinary fees.

In all these cases, the association or private institution must be officially recognised as a VAT exempted entity by the taxation authorities.[17]

III. DEDUCTIONS FOR CHARITABLE DONATIONS TO NON-PROFIT ORGANISATIONS

A. Deductions to individuals

The State's Budget Act for 1989 provides for a 15% deduction for donations to the State ("Historical National Patrimony"). Similarly, the same deduction is also set up for individuals who donate to non-profit organisations, such as entities of social provision, etc. In both cases, however, the deduction can increase to 30% of the individual taxable income.

B. Deductions to corporations

Similar deductions are also allowed for corporations, simply because donations to non-profit organisations are considered deductible expenses.[18] The amount of the donation is limited to 10% of the taxable income, however. The same deduction and limitation are also applicable to donations to the Spanish State.

IV. INTERNATIONAL ASPECTS OF CHARITABLE DONATIONS

A. Recognition of foreign charitable organisations under Spanish law

As previously explained, when considering the corporate tax exemptions, the administrative recognition of the "public utility" of an entity is necessary for any organisation wishing to benefit from such an exemption. Thus, constant recognition by Spanish law will be a preliminary requisite. Both continuous legal existence and recognition as a "public utility" are required of foreign associations organized to collect funds with a view to a charitable purpose. From the donor's point of view, whether individual or corporate, this is crucial because the deductibility of any contributions to a foreign charity depends totally upon the status of that charity.

Consequently, a donation by a corporate resident in Spain will not be considered deductible under the Spanish Corporate Tax Act if the beneficiary is not an entity recognized by Spanish law. In the case of charitable contributions to foreign corporations, the transfer of funds will be, in any case, subject to administrative authorisation.[19]

As for non-resident corporations with continued activities in Spain through a permanent establishment, their benefits are subject to the same rules as resident corporations.[20] Therefore, deductions by a non-resident corporation are allowed for charitable contributions to a qualified non-profit entity. Again, the deduction is limited to 10% of taxable income. On the other hand, charitable contributions by non-resident individuals are not deductible.[21]

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INTERNATIONAL:

Revenue Statistics of OECD Member Countries 1965-1988[1]

The OECD recently released its annual publication providing information on tax levels and structures in OECD Member countries. Some of its conclusions are summarized below.

The ratio of total tax revenues to Gross Domestic Product (GDP) is widely used as an indicator of the relative weight of taxation in any one country over a period of time or when countries are compared for the same period. For valid comparisons to be made, all taxes and compulsory contributions have to be included in a consistent manner. Data published by the OECD for many years are designed to do this. The latest figures just published relate to 1987 with provisional estimates for 1988. They show that for 1987, as during nearly all the last 17 years, Belgium, Denmark, the Netherlands, Norway and Sweden had the highest ratios (over 45% for 1987). At the other extreme are Japan, Turkey and the United States, with ratios of 30% or below (see Table).

Between 1986 and 1987 there was an increase in the tax ratio of 16 countries and a decrease in 7.[2] Provisional estimates for 1988 show that in 9 of the 15 countries where data are available, the level of taxation fell and in 6 it increased. This is the first time since these data have been published that tax to GDP ratios have fallen in a large number of countries, although this reduction was substantial only in Canada, Norway, Sweden and Turkey.

The publication enables comparisons to be made of the relative reliance on different sources of revenue in Member countries. In 1987, Australia, Denmark and New Zealand obtained more than 50% of tax revenue from taxes on income and profits, whereas consumption taxes were the major source of revenue in Austria, Greece, Ireland, Norway and Portugal and social security contributions in France, Germany, the Netherlands and Spain. In all countries, these 3 sources of revenue account for more than 85% of total tax receipts.

During the last 3 years the trend in a number of countries (Finland, Greece, New Zealand, Norway, Portugal, Spain, Turkey) has been to increase the relative reliance on consumption taxes, particularly the VAT which is now in operation in 20 Member countries (all except Australia, Canada (where it is likely to be introduced shortly), Switzerland and the United States). Another recent tendency is the fall in the relative importance of personal income tax. In New Zealand, Norway and Turkey, for example, the proportion of tax revenues obtained from this tax has substantially fallen.

1. 258 pages, OECD, Paris 1989. F180, £22, US$38, DM74. ISBN 92-64-03236-3. Available from OECD Publications Distributors.
2. The publication refers to all OECD Member countries except Iceland for which data are not at present available.
3. Ranked by the 1987 figures. Classement sur la base des chiffres de 1987.

Table 1

Total tax revenue as percentage of GDP at market prices[3]

	1980	1981	1982	1983	1984	1985	1986	1987	1988*
Sweden	49.4	51.1	49.9	50.6	50.3	50.6	53.7	56.7	55.5
Denmark	45.5	45.3	44.5	46.5	47.6	49.0	51.0	52.0	52.0
Norway	47.1	48.7	47.9	46.6	45.8	47.6	49.9	48.3	46.9
Netherlands	45.8	45.2	45.4	46.7	45.0	44.9	45.9	48.0	
Belgium	43.5	44.0	45.4	45.3	46.3	46.5	45.8	46.1	
France	41.7	41.9	42.8	43.6	44.6	44.5	44.1	44.8	44.3
Luxembourg	40.9	40.7	40.9	44.9	43.2	43.6	42.8	43.8	
Austria	41.2	42.5	41.2	41.1	42.4	43.1	42.9	42.3	41.9
Ireland	34.0	35.2	36.8	38.3	39.0	38.4	39.5	39.9	42.7
New Zealand	33.1	34.1	35.0	32.8	32.9	33.9	34.9	38.6	
Germany	38.0	37.6	37.4	37.3	37.5	38.0	37.6	37.6	37.4
United Kingdom	35.3	36.7	39.1	37.6	37.8	37.8	38.5	37.5	37.7
Greece	29.4	29.6	33.4	33.3	34.9	35.2	36.8	37.4	
Italy	30.2	31.4	33.7	35.8	34.8	34.4	36.1	36.2	37.1
Finland	33.0	34.6	34.0	34.0	35.5	36.8	38.1	35.9	37.9
Canada	31.6	33.7	33.5	33.0	32.9	32.9	33.2	34.5	33.6
Spain	24.1	25.5	25.8	27.9	29.2	29.1	31.0	33.0	32.8
Switzerland	30.8	30.6	31.0	31.6	32.3	32.0	32.5	32.0	32.2
Portugal	28.7	30.4	31.1	32.9	32.2	31.6	33.4	31.4	34.9
Australia	29.0	29.9	29.9	29.2	30.7	30.4	31.0	31.3	
Japan	25.5	26.2	26.7	27.2	27.4	28.0	28.9	30.2	
United States	29.5	30.0	29.9	28.4	28.4	29.2	28.9	30.0	
Turkey	21.7	23.4	22.4	20.7	17.3	19.7	22.8	24.7	22.7
unweighted average:									
OECD Total	35.2	36.0	36.4	36.7	36.9	37.3	38.2	38.8	
OECD Europe	36.7	37.5	37.9	38.6	38.7	39.0	40.1	40.4	
EEC	36.4	37.0	38.0	39.2	39.3	39.4	40.2	40.6	

* Provisional — Blank = not available.

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